In The

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1969

NO. 412

FRED W. WOODWARD and ELSIE M. WOODWARD,
F. R. WOODWARD and M. JEANNE WOODWARD,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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The minutes of a special meeting of the common stock shareholders of the Telegraph-Herald, held on June 9, 1960, containing a Resolution duly adopted, pursuant to the statutory procedural requirements of Section 491.25 of the 1958 Code of Iowa, by a majority of all of the issued and outstanding common stock of the said corporation, renewing and extending its corporate existence perpetually 9

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The Petition in Equity filed, pursuant to Section 491.25 of the 1958 Code of Iowa, by the majority (affirmative voting) shareholders of the Telegraph-Herald, with the exception of Charles Murphy, Executor of the Estate of Ellen Murphy, Deceased, on February 9, 1962, in the District Court of Iowa in and for Dubuque County, asking such Court to determine and fix the real value of the dissenting shareholder's common stock of the Telegraph-Herald 15

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IN THE
UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

Fred W. Woodward and Elsie M. Woodward,
F. R. Woodward and M. Jeanne Woodward
Petitioners

v

Commissioner of Internal Revenue
Respondent

RELEVANT DOCKET ENTRIES

Date	Filings—Proceedings
July 22, 1968	Certified Transcript of Proceedings before the Tax Court of the United States, filed; cause Docketed.
March 11, 1969	Cause argued to Judges Matthes, Mehaffy and Lay; cause submitted.
May 2, 1969	Opinion by Judge Matthes, filed.
	Judgment of Court: Decision of the Tax Court of the United States affirmed; and, Petition to Review dismissed.
May 26, 1969	Mandate issued.

STIPULATION OF FACTS IN THE TAX COURT OF THE UNITED STATES—FILED JULY 22, 1968

It is hereby stipulated that, for the purpose of these cases, the following statements may be accepted as facts and all exhibits referred to herein and attached hereto are incorporated in this stipulation and made a part

hereof; subject to the right of any party to object to the admission of such facts in evidence on the grounds of materiality and relevancy; provided, however, that any party may introduce other and further evidence not inconsistent with the facts herein stipulated.

1. Petitioners, Fred W. Woodward and Elsie M. Woodward, are husband and wife and reside at 1090 West 3rd Street, Dubuque, Iowa. They filed a joint federal income tax return for the taxable year 1963 with the District Director of Internal Revenue at Des Moines, Iowa. A copy of said return is attached hereto and marked Exhibit A.

2. Petitioners, F. R. Woodward and M. Jeanne Woodward, are husband and wife and reside at 384 Wartburg Place, Dubuque, Iowa. They filed a joint federal income tax return for the taxable year 1963 with the District Director of Internal Revenue at Des Moines, Iowa. A copy of said return is attached hereto and marked Exhibit B.

3. Petitioners, F. R. Woodward and M. Jeanne Woodward, are the son and daughter-in-law, respectively, of petitioners, Fred W. Woodward and Elsie M. Woodward.

4. The Telegraph-Herald is a profit corporation organized under the laws of the State of Iowa. Said corporation is engaged in publishing a daily newspaper, operating a commercial printing plant and operating a radio station in Dubuque, Iowa.

5. On June 9, 1960, the Telegraph-Herald had 1200 shares of common stock issued and outstanding. Ownership of said shares on that date was as follows:

Common Stockholder	Number of Shares
Fred W. Woodward	398
F. R. Woodward	58
M. Jeanne Woodward	55
Elsie M. Woodward, F. Robert Woodward, M. Jeanne Woodward and American Trust & Savings Bank of Dubuque, Iowa, as Trustees of Fred W. Woodward Trust No. 1	200
Elsie M. Woodward, F. Robert Woodward, M. Jeanne Woodward and American Trust & Savings Bank of Dubuque, Iowa, as Trustees of Fred W. Woodward Trust No. 2	100
Charles Murphy, Executor of the Estate of Ellen Murphy, Deceased	10
Margaret M. Quigley	379
Total	1,200

6. The Telegraph-Herald was originally incorporated in 1901. Its corporate existence was renewed in 1921 and 1941, and under the 1941 renewal its corporate existence was extended 20 years to November 1, 1961. The common stockholders of the Telegraph-Herald held a special meeting on June 9, 1960, for the purpose of renewing and extending its corporate existence and to consider placing certain restrictions on its common stock.

7. At the special stockholders' meeting on June 9, 1960, which was attended by all of the common stockholders or their representatives, a resolution was duly adopted by a majority of all the stockholders extending the Telegraph-Herald's corporate existence perpetually. A copy of the minutes of said special meeting is attached hereto and marked Exhibit 1.

8. A certificate for the renewal of the Telegraph-Herald's corporate charter was issued by the Secretary of State for the State of Iowa, on or about June 10, 1960.

9. Of the Telegraph-Herald's 1200 shares of common stock issued and outstanding all voted in favor of the renewal of the corporate existence except the 379 shares owned by Margaret M. Quigley.

10. Section 491.25 of the Iowa Code Annotated provides as follows:

"491.25 Renewal—procedure

'Corporations existing for a period of years may be renewed from time to time for the same or shorter periods, or may be renewed to exist perpetually, upon compliance with the provisions of this section and other applicable statutes.

'The right of renewal is vested in the stockholders and shall be exercised by a resolution thereof adopted at any regular meeting or at any special meeting called for that purpose. Such resolution must be adopted by a majority of all the votes cast at such meeting, or by such other vote as is authorized or required in the company's existing articles of incorporation.

'If the renewal instrument in proper form and the necessary fees are tendered to the secretary of state for filing three months or less either prior or subsequent to the corporation's expiration date, such renewal shall take effect immediately upon the expiration of the corporation's previous period of existence, and in such case, the corporate existence shall be considered as having been extended without interruption. If the renewal is filed more than three months before or after the expiration date, such renewal shall take effect upon the date such renewal with neces-

sary fees is accepted and filed by the secretary of state; and in cases where filed more than three months after the expiration date, shall not be in legal effect a renewal unless the procedure provided for and the additional fees provided for in section 491.28 are fully complied with and paid.

'In all cases of renewal, those stockholders voting for such renewal must purchase at its real value the stock voted against such renewal, and shall have three years from the date such action for renewal was taken in which to purchase and pay for the stock voting against such renewal, which purchase price shall bear interest at the rate of five percent per annum from the date of such renewal action until paid. As amended, Acts 1955 (56 G. A.), ch. 229, § 1."

11. The majority stockholders voting to extend the corporate existence of the Telegraph-Herald and Margaret M. Quigley were unable to agree upon the real value of the latter's stock. The majority stockholders, with the exception of Charles Murphy, Executor of the Estate of Ellen Murphy, Deceased, on February 9, 1962, filed a Petition in Equity in the District Court of Iowa, in and for Dubuque County, asking the Court to determine and fix the real value of Margaret M. Quigley's stock; a copy of such petition is attached hereto and marked Exhibit 2. The decision entered by the District Court establishing a value of $1,750 per share was appealed by all parties to the Supreme Court of Iowa. A copy of the District Court's Findings of Fact, Conclusions of Law and Decree Fixing "Real Value" is attached hereto and marked Exhibit 3.

12. In the case of **Woodward v. Quigley**, 133 N. W. 2d 38 (Iowa 1965), the Supreme Court of Iowa determined the real value of Margaret M. Quigley's shares to be $1,650 per share. On rehearing the Supreme Court of

Iowa in **Woodward v. Quigley**, 136 N. W. 2d 280 (Iowa 1965), redetermined the real value of Margaret M. Quigley's stock in the Telegraph-Herald to be $1,620 per share. Both of said opinions of the Supreme Court of Iowa are, by this reference thereto, made a part of this stipulation as if fully set forth herein.

13. Subsequent to the entry of final judgment in **Woodward v. Quigley**, *supra*, the 379 shares of Telegraph-Herald stock owned by Margaret M. Quigley were purchased on July 16, 1965, by the majority stockholders voting to extend the corporate existence of the Telegraph-Herald as follows:

Purchaser	Number of Shares Purchased
F. W. Woodward	184
F. R. Woodward	27
M. Jeanne Woodward	25
Trust No. 1	92
Trust No. 2	46
Estate of Ellen Murphy	5
Total	379

14. During the taxable year 1963 the majority stockholders voting to extend the corporate existence of the Telegraph-Herald, with the exception of Charles Murphy, Executor of the Estate of Ellen Murphy, Deceased, paid attorneys', accountants', and appraisers' fees, costs and disbursements in the total amount of $37,890.75 for services rendered in connection with the determination of the real value of Margaret M. Quigley's stock as follows:

Description of Expenses	Amount of Payment
Clewell, Cooney & Fuerste (Attorneys' Fees)	$17,224.14
American Appraisal Company	8,684.40
Ernst & Ernst (Accounting Fees)	5,485.00
Reporting Services	4,635.76
Miscellaneous	1,861.45
Total	$37,890.75

15. The proportionate share of the fees, costs and disbursements, referred to in paragraph 14, above, paid by petitioner, Fred W. Woodward, during the taxable year 1963 was $20,072.23.

16. The proportionate share of the fees, costs and disbursements, referred to in paragraph 14, above, paid by petitioners, F. R. Woodward and M. Jeanne Woodward, during the taxable year 1963 was $5,931.51.

17. Petitioners, Fred W. Woodward and Elsie M. Woodward, claimed the $20,072.23 anount, referred to in paragraph 15, above, as an itemized deduction under "Other Deductions" on their federal income tax return for the taxable year 1963 (Exhibit A).

18. Petitioners, F. R. Woodward and M. Jeanne Woodward, claimed the $5,931.51 anount, referred to in paragraph 16, above, as an itemized deduction under "Other Deductions" on their federal income tax return for the taxable year 1963 (Exhibit B)

19. Respondent concedes that the fees, costs and disbursements, paid by Petitioners as set forth in paragraphs 15 and 16, above, were reasonable in amount and with the exceptions of $185.00 and $85.00 noted in paragraphs 20 and 21 hereof, respectively, were incurred in connection with the determination of the real value of Margaret M. Quigley's shares of stock in the Telegraph-Herald.

20. The respondent concedes that $185.00 of the $20,072.23 deduction for professional fees, disallowed in adjustment (a) on page 1 of the statement attached to the statutory notice of deficiency (Docket No. 4363-65), is an allowable deduction because said $185.00 was paid for professional services rendered in the preparation of a gift tax return and federal and state income tax returns for the taxable year 1962.

21. The respondent concedes that $85.00 of the $5,931.51 deduction for professional fees, disallowed in adjustment (a) on page 1 of the statement attached to the statutory notice of deficiency (Docket No. 4364-65), is an allowable deduction because said $85.00 was paid for professional services rendered in the preparation of petitioners' federal and state income tax returns for the taxable year 1962.

22. If respondent's determination in Docket No. 4363-65 is not sustained by the Court, the respondent concedes that petitioners therein were not required to include the $3,600.00 received by Elsie M. Woodward from the Fred W. Woodward Trust No. 1 as income in their federal income tax return for the taxable year 1963.

23. Petitioners, Fred W. Woodward and Elsie M. Woodward filed a claim for refund for overpayment of their income tax for taxable year 1963 in the amount of $1,134.47 with the District Director of Internal Revenue for the District of Iowa on July 19, 1965.

Donald P. Cooney
Counsel for Petitioners

Lester R. Uretz
Chief Counsel, Internal Revenue Service

PETITIONERS' EXHIBIT 1

Special Meeting of the Stockholders of Telegraph-Herald

June 9, 1960

A special meeting of stockholders of Telegraph-Herald was held at the office of the Company, 8th Avenue and Bluff Street, Dubuque, Iowa, on June 9, 1960, at 10:00 o'clock A. M. pursuant to the following notice:

To the Holders of Capital Stock of Telegraph-Herald:

Notice Is Hereby given that by direction of the President a special meeting of the stockholders of Telegraph-Herald will be held at the office of the Company, West 8th and Bluff Streets in the City of Dubuque, Iowa, on Thursday, June 9, 1960 at 10:00 o'clock A. M. for the purpose of considering and acting upon amending the Amended, Substituted and Renewal Articles of Incorporation of said corporation in the following respects:

1. By amending Article I of said Articles of Incorporation in such manner as to strike out the date of November 1, 1961 for the expiration of its corporate period and substitute in lieu thereof a provision giving the corporation perpetual existence.

2. By amending Article IV of said Articles of Incorporation by adding thereto the following provision:

> "Before any stock may be sold and transferred on the books of the corporation, the owner of such stock shall give notice in writing to the Secretary stating the number of shares proposed to be sold, the person or persons to whom and the price at which it is proposed to sell the same. The corporation, by appropriate action of the Board of Directors, shall have the right to purchase said

stock at the price so stated, and if the corporation does not purchase said stock the same shall be offered for sale to the other shareholders in the proportion of their current holdings. If neither the corporation nor the shareholders elect to purchase said stock within thirty days from the date on which the Secretary receives notice of intention to sell as above set out, then the owner of said stock shall have the right to sell the same to the person or persons and at the price so stated in the notice."

Dubuque, Iowa, May 24, 1960.

F. R. Woodward
Secretary

The following were present at the meeting: F. W. Woodward, F. R. Woodward, Elsie M. Woodward, M. Jeanne Woodward, Margaret Quigley, Charles J. Murphy, executor of the estate of Ellen Murphy, deceased, Tharsella Pins and Attorneys F. J. O'Connor, E. Marshall Thomas and Robert W. Clewell.

It was moved and seconded that F. W. Woodward act as Chairman of the meeting and F. R. Woodward act as Secretary. Motion carried.

At the request of Mr. O'Connor the names of the stockholders and the number of shares in the name of each stockholder were read as follows:

F. W. Woodward	398	shares
Fred W. Woodward Trust No. 1	200	"
Fred W. Woodward Trust No. 2	100	"
Margaret Quigley	379	"
Ellen Murphy (Charles J. Murphy, executor)	10	"
F. R. Woodward	58	"
M. Jeanne Woodward	55	"
Total	1200	"

The Secretary reported that all of the outstanding shares of stock were represented at the meeting in person.

Referring to the proposed amendments mentioned in the call of the meeting, Mr. Clewell commented on the advantages to a corporation of a provision giving it and the stockholders the first opportunity of purchasing any stock proposed to be sold and transferred on the books of the corporation, stating that such a provision is in quite general use and is regarded as a safeguard against the distribution of shares to those of a succeeding generation and others not closely associated in the Company. Referring to the proposed amendment providing for perpetual existence, he called attention to the fact that the present corporate period will expire November 1, 1961, at or prior to which time it seems likely that the corporation will elect to adopt the provisions of the new Iowa Business Corporation Act which, among other advantages, authorizes perpetual duration.

At the direction of the Chairman the following resolution which had been prepared for submission to the meeting, was read:

Resolution.

Resolved by the stockholders of Telegraph-Herald that Article I of the Renewal, Amended and Substituted Articles of Incorporation of this corporation is amended by striking out all of said Article I and substituting in lieu thereof the following:

"Article I.

The name of this corporation is Telegraph-Herald and its office and principal place of business is in the City of Dubuque, in Dubuque County, State of Iowa. It commenced business under its original articles of incorporation on the 1st day of November, 1901. Its corporate period has been renewed from

time to time and by amendment adopted at a special meeting of stockholders held on June 9, 1960, this corporation shall have perpetual existence from and after the date on which the certificate of said amendment is issued by the Secretary of State of the State of Iowa. This corporation may be dissolved by a vote of the holders of not less than three-fourths of the total number of shares of stock issued and outstanding."

and

Resolved Further that Article XII of the Renewal, Amended and Substituted Articles of Incorporation of this corporation is amended by adding thereto the following:

"Before any stock may be sold and transferred on the books of the corporation, the owner of such stock shall give notice in writing to the Secretary stating the number of shares proposed to be sold, the person or persons to whom and the price at which it is proposed to sell the same. The corporation, by appropriate action of the Board of Directors, shall have the right to purchase said stock at the price so stated, and if the corporation does not purchase said stock the same shall be offered for sale to the other shareholders in the proportion of their current holdings. If neither the corporation nor the shareholders elect to purchase said stock within thirty days from the date on which the Secretary receives notice of intention to sell as above set out, then the owner of said stock shall have the right to sell the same to the person or persons and at the price so stated in the notice."

Resolved Further that the President and Secretary of this corporation are designated as the officers to sign and acknowledge said Amendments to Renewal,

Amended and Substituted Articles of Incorporation and a suitable certificate thereof, to file and record the same, to publish notice thereof and to take such other steps and to do such other acts and things as deemed advisable in the premises.

A motion to adopt the resolution was made and seconded.

A discussion followed.

Mr. O'Connor requested that detailed financial statements be furnished to his client Margaret Quigley. The Chairman replied that copies of the auditor's reports are available and may be obtained by the stockholders but that the financial statements in detail have never been permitted to leave the office or even be available for inspection by employees in the office. In behalf of Margaret Quigley an exception and objection was noted to the refusal of the officers to furnish such detailed statements. The officers explained, however, that any stockholder, either personally or by attorney or agent, would be afforded an opportunity to examine the books and records and make copies of such portions as they desired with the admonition that any circulation of same would be extremely detrimental to the best interests of the corporation.

Mr. O'Connor then inquired about the expansion program and its probable cost. Mr. F. R. Woodward stated that the estimate was around a million dollars and of that amount the proposed new press, which would be the costliest item, would run around $600,000.00. He said that the Company wishes to avoid the necessity of borrowing to any greater extent than necessary, that up to now around $300,000.00 has been saved for the program and by waiting a few years longer a large indebtedness and a very considerable amount of interest will be avoided. Mr. O'Connor then requested information as to the compensation paid the President and Secretary. The Chair-

man requested Miss Pins to obtain the figures from Mr. Kane. Upon returning she had the figures and it was agreed that the salaries were quite moderate.

Mr. Murphy spoke to Mr. Clewell about the procedure and indicated that in his opinion a minority stockholder would be better protected if the articles were renewed for a definite number of years. There being no further discussion a vote was taken upon the motion to adopt the resolution and upon roll call the vote was as follows:

F. W. Woodward .....Yes
Fred W. Woodward Trust No. 1 (voted by F. R. Woodward, Trustee) .....Yes
Fred W. Woodward Trust No. 2 (voted by F. R. Woodward, Trustee) .....Yes
Margaret Quigley .....No

Before voting the Ellen Murphy stock, Charles J. Murphy requested an additional explanation as to what the effect would be if he voted "yes" or voted "no" on the motion. Mr. Clewell advised him that the corporation shall have perpetual existence if the resolution is adopted by a majority vote in which case the stockholders voting for the same must purchase at its real value the stock voted against the resolution and shall have three years in which to purchase and pay for the stock with interest at the rate of 5% per annum. Thereupon Mr. Murphy voted .....Yes
F. R. Woodward .....Yes
M. Jeanne Woodward .....Yes

Thereupon the Chairman declared the resolution adopted by a majority of all the votes cast at the meeting.

Mr. Murphy then stated that he was still of the opinion that a renewal for a shorter duration would be better. Mr. Clewell advised him that having voted in the affirma-

tive he is in the parliamentary position to move to reconsider the action taken. Mr. Murphy moved to reconsider the action upon the resolution but the motion failed for want of a second.

There being no further business, the meeting adjourned.

F. R. Woodward
Secretary

PETITIONERS' EXHIBIT 2

In the District Court of Iowa in and for Dubuque County

F. W. Woodward, F. R. Woodward, M. Jeanne Woodward; and Elsie M. Woodward, F. Robert Woodward, M. Jeanne Woodward and American Trust & Savings Bank, Dubuque, Iowa, Trustees of Fred W. Woodward Trust No. 1; and Elsie M. Woodward, F. Robert Woodward, M. Jeanne Woodward and American Trust & Savings Bank, Dubuque, Iowa, Trustees of Fred W. Woodward Trust No. 2,

Plaintiffs,

vs.

Margaret M. Quigley,

Defendant.

No. 80,257

Petition in Equity

Plaintiffs state:

Par. 1. That the Plaintiffs, F. W. Woodward, F. R. Woodward and M. Jeanne Woodward, are the owners of

capital stock of Telegraph-Herald, an Iowa corporation, with its principal place of business in the City of Dubuque, Dubuque County, Iowa, that the Plaintiffs, Elsie M. Woodward, F. Robert Woodward, M. Jeanne Woodward and American Trust & Savings Bank, Dubuque, Iowa, an Iowa corporation, as Trustees of the Fred W. Woodward Trust No. 1, are the owners of capital stock of said corporation; that the Plaintiffs, Elsie M. Woodward, F. Robert Woodward, M. Jeanne Woodward and American Trust & Savings Bank, Dubuque, Iowa, an Iowa corporation, as Trustees of the Fred W. Woodward Trust No. 2, are the owners of capital stock of said corporation.

That each and all of said Plaintiffs are residents of Dubuque County, Iowa.

Par. 2. That the Defendant Margaret M. Quigley is a resident of Dubuque County, Iowa, and an owner of capital stock in said corporation.

Par. 3. That as of June 9, 1960, the Plaintiffs and the Defendant were the owners of all of the outstanding capital stock of said corporation except for ten shares owned by the Estate of Ellen E. Murphy, deceased, of which Charles J. Murphy was the duly appointed, qualified and acting Executor.

Par. 4. That a special meeting of the stockholders of the corporation was held at its office in the City of Dubuque, Iowa, on June 9, 1960 at 10:00 o'clock A. M., due notice of which meeting had been given to all holders of capital stock of the corporation.

That all of the capital stockholders were present or represented at said meeting.

Par. 5. At said special meeting of the stockholders of said corporation a resolution was duly adopted by a vote

of the majority of all of the outstanding capital stock of said corporation, renewing and extending perpetually its corporate existence.

Par. 6. That all of the capital stockholders except the Defendant voted to renew the Articles of Incorporation and the Defendant voted against renewal.

Par. 7. That Section 491.25 of the 1958 Code of Iowa provides as follows:

> "In all cases of renewal, those stockholders voting for such renewal must purchase at its real value the stock voted against such renewal, and shall have three years from the date such action for renewal was taken in which to purchase and pay for the stock voting against such renewal, which purchase price shall bear interest at the rate of five percent per annum from the date of such renewal action until paid."

Par. 8. That the Plaintiffs and Defendant have been unable to agree as to the real value of the Defendant's stock as of June 9, 1960, the day the renewal resolution was adopted.

Wherefore, Plaintiffs ask that the Court determine and fix the real value of the Defendant's Telegraph-Herald capital stock as of June 9, 1960, for costs and for such other and further relief as shall be just and equitable.

Robt. W. Clewell and
M. M. Cooney
Members of the Firm of
Clewell, Cooney & Fuerste
705 Roshek Building
Dubuque, Iowa
Attorneys for Plaintiffs

PETITIONERS' EXHIBIT 3

In the District Court of Iowa in and for Dubuque County

F. W. Woodward et al.
vs.
Margaret M. Quigley.
} Equity No. 80257.

Findings of Fact, Conclusions of Law and Decree Fixing "Real Value"

This case came on for trial on September 17th, 1962, the plaintiffs appearing by M. M. Cooney and Donald Cooney of the firm of Clewell, Cooney & Fuerste, and the defendant appearing by Francis J. O'Connor and E. Marshall Thomas of the firm of O'Connor, Thomas, McDermott & Wright, and the submission of evidence was completed on the 26th day of October 1962. Counsel having filed written briefs and arguments and the Court having heard oral arguments of counsel on April 30th and May 1st, 1963, and the Court now being fully advised hereby makes the following Findings of Fact, Conclusions of Law and Decree Fixing the "Real Value" of defendant's stock of Telegraph-Herald as of June 9, 1960, as follows:

Findings of Fact

1. Telegraph-Herald is an Iowa profit corporation and was originally incorporated in 1901. Its corporate existence was renewed in 1921 and 1941, and under the 1941 renewal its corporate existence was extended 20 years to November 1, 1961.

2. On June 9, 1960, the outstanding capital stock of Telegraph-Herald consisted of 1,200 shares of $100 par value common stock, which stock was owned by the following persons:

F. W. Woodward .....398 Shares
F. R. Woodward ..... 58 Shares
M. Jeanne Woodward ..... 55 Shares
Elsie M. Woodward, F. Robert Woodward, M. Jeanne Woodward, and American Trust & Savings Bank, Dubuque, Iowa, Trustees of Fred W. Woodward Trust No. 1 .....200 Shares
Elsie M. Woodward, F. Robert Woodward, M. Jeanne Woodward and American Trust & Savings Bank, Dubuque, Iowa, Trustees of Woodward Trust No. 2 ....100 Shares
Ellen Murphy, deceased, Charles J. Murphy, Executor ..... 10 Shares
Margaret M. Quigley, defendant .....379 Shares

3. At a special meeting of the stockholders of Telegraph-Herald, held on June 9, 1960, the Articles of Incorporation of Telegraph-Herald were amended to provide, among other matters, perpetual existence for said corporation. All of the outstanding stock of Telegraph-Herald was represented at such meeting in person or by proxy and was voted in favor of said amendments, except the 379 shares, owned by the defendant, Margaret M. Quigley, which were voted against the renewal of corporate existence.

4. On June 9, 1960, and for many years prior thereto, Telegraph-Herald owned and published the "Telegraph-Herald," a daily newspaper, published six days a week, Monday through Friday and on Sunday, and owned and operated radio station KDTH in Dubuque, Iowa, operating on AM frequency with 1 kilowatt power. On June 9, 1960, the Telegraph-Herald corporation was also the owner of all the outstanding common stock, consisting of 100 shares of $100 par value, of Visual Education Center, Inc., which was engaged in selling educational filmstrips and other educational material for publication in newspapers.

5. The plaintiffs are the persons listed in Findings of Fact No. 2, except the owners of the Murphy stock and the defendant, Margaret M. Quigley.

6. Plaintiff F. W. Woodward is and was at all times relevant hereto the President and Publisher of Telegraph-Herald. Plaintiff F. R. Woodward is the son of F. W. Woodward and is and was at all times relevant hereto the Secretary and Treasurer and General Manager of Telegraph-Herald. Plaintiff M. Jeanne Woodward is the wife of F. R. Woodward and plaintiff Elsie M. Woodward is the wife of F. W. Woodward. M. R. Kane is and was at all times relevant hereto the Vice President of Telegraph-Herald.

7. The Board of Directors of Telegraph-Herald in 1960 and for many years prior thereto was as follows: F. W. Woodward, F. R. Woodward, M. Jeanne Woodward, Elsie M. Woodward and M. R. Kane.

8. The defendant Margaret M. Quigley has never been an officer or director of Telegraph-Herald.

9. Margaret M. Quigley acquired her 379 shares of stock of Telegraph-Herald by bequest from her husband, Joseph C. Quigley, who died January 22, 1952.

10. On June 9, 1960, and for many years prior thereto the Telegraph-Herald newspaper was the only daily newspaper published in the City of Dubuque, or in the County of Dubuque, Iowa.

• • • • • • • •

33. The common capital stock of the Telegraph-Herald has not been sold or offered for sale nor have any bids been made to purchase said stock during the years 1950 to June 9, 1960.

• • • • • • • •

Conclusions of Law

1. The Court has jurisdiction of the parties and the subject matter hereof.

2. This is an equitable proceeding to fix and determine the real value of defendant's 379 shares of stock in the Telegraph-Herald corporation as of June 9, 1960, under section 491.25 Code of Iowa, said stock having been voted against renewal of the corporate charter on said date.

3. That plaintiffs (together with owner of 10 shares of Murphy stock) voted for the renewal of the corporate charter of Telegraph-Herald on June 9, 1960 and have the obligation to purchase defendant's 379 shares of stock of Telegraph-Herald at its "real value" under Section 491.25 Code of Iowa plus interest thereon at the rate of 5% per annum from June 9, 1960 until paid.

4. "Real Value" as used in Section 491.25 of the Code of Iowa, does not mean market value of the minority interest.

Robbins v. Beatty, 246 Iowa 80, 67 N. W. 2d 12 (1954).

Note: The authorities in other jurisdictions generally agree that the terms "value," "actual value," "true," "fair" or "real" value of minority stock in merger or consolidation cases do not mean market value of the minority interest.

Tri-Continental Corp. v. Battye, Del. Ch. 74 A. (2d) 71;

American General Corporation v. Camp, 171 Md. 629;

In Re Fulton, 257 N. Y. 487, 178 N. E. 766 (1921);

Petry v. Harwood Electric Co., 280 Pa. 142, 124 Atl. 302 (1924);

Republic Finance & Investment Company v. Fenstermaker, 211 Ind. 251, 6 N. E. (2d) 541 (1937);

Roessler v. Security Savings & Loan Co., 72 N. E. (2d) 259 (1947).

5. "Real Value" as used in Section 492.25 of the Code of Iowa, means intrinsic value, determined from a consideration of every relevant factor bearing upon the question of value.

6. In determining real value under Section 491.25, Code of Iowa, no reduction should be made on account of brokerage fees, flotation costs, or lack of marketability.

7. The real value of the 379 shares of stock of the Telegraph-Herald owned by defendant Margaret M. Quigley as of June 9, 1960, was $1,750.00 per share, or a total of $663,250.00.

8. The costs of this case are taxed to the parties as follows: 68% to plaintiffs and 32% to defendant.

Decree

It is, therefore, Ordered, Adjudged and Decreed that the "real value" of the 379 shares of common capital stock of Telegraph-Herald owned by the defendant, Margaret M. Quigley as of June 9, 1960, was $1,750.00 per share, or a total of $663,250.00 and the costs are taxed herein as follows: 68% to plaintiffs and 32% to the defendant.

Dated this 18th day of May, 1963.

By the Court:

Eugene J. Kean
Judge
XIXth Judicial District of Iowa

OPINION

In the
Supreme Court of Iowa

No. 51390

Woodward, et al. v. Quigley

February 9, 1965

(133 N. W. 2d 38)

At page 39 of 133 N. W. 2d, the Court speaking through Justice Stuart, stated as follows, to-wit:

"The corporate life of the Telegraph-Herald, a newspaper in Dubuque, Iowa, was due to expire December 31, 1961. At a special stockholders' meeting on June 9, 1960, a resolution was duly adopted by a majority of all the stockholders extending the corporate existence perpetually. Of the 1200 shares of stock outstanding all voted in favor of the renewal except the 379 shares owned by defendant. Section 491.25 of the Code, I. C. A., provides in part:

'In all cases of renewal, those stockholders voting for such renewal must purchase at its real value the stock voted against such renewal, and shall have three years from the date such action for renewal was taken in which to purchase and pay for the stock voting against such renewal, which purchase price shall bear interest at the rate of five percent per annum from the date of such renewal action until paid.'

Plaintiffs recognized their obligation to purchase the stock under this statute, but the parties have been unable to agree on the 'real value' of defendant's stock. This action was brought by the majority stockholders to secure a court determination of its 'real value'. The trial court established a value of $1,750 per share and both parties have appealed."

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The Court, at page 42 of 133 N. W. 2d enunciated the object or standard inherent in the appraisal statute; to-wit:

"Our 'real object is to ascertain the actual worth of that which the dissenter loses because of his unwillingness to go along with the controlling stockholders, that is, to indemnify him'. Warren v. Baltimore Transit Company, 220 Md. 478, 154 A. 2d 796."

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The Court traced the legislative history of the appraisal statute as follows on page 42 of 133 N. W. 2d; to-wit:

"Before turning to a discussion of the investment value of defendant's stock, we must dispose of two propositions urged by plaintiffs which directly affect its real value. Plaintiffs' valuation witnesses arrived at the real value of defendant's stock by giving an opinion as to the value of the stock in the corporation per share and then discounting that value (1) for a broker's commission and (2) because defendant's share represented a minority interest. Plaintiffs argue that these are 'relevant factors' to be considered in determining the real value or intrinsic worth of defendant's share in the corporation. We do not agree with this argument.

Defendant's stock is to be valued as in a 'going concern'. Plaintiffs have repeatedly urged this proposition.

We believe their arguments on these two propositions are a departure from that principle. These factors would be present only in the event of a sale of stock and would therefore be more likely to affect market value of the stock than investment value. There is no reason to consider either of these factors here. It was necessary to consider liquidation value of the assets to protect the minority from an arbitrary action by the majority. In these instances there are no brokerage commissions to be paid in fact and the majority will not be subject to the handicaps of a minority stockholder by such a purchase.

We also believe that consideration of such factors would negative one of the main purposes of section 491.25. The original statute was similar to those enacted in most states to modify the common law rule which required unanimous consent of all the stockholders for a substantial change in the corporate structure. The increase in the number of corporations and stockholders made such a rule impracticable. The statute was enacted to permit a majority to vote to renew the corporate life and at the same time allow a dissenting minority to get out of the corporation with the "real value" of its stock. It prevented the minority from being squeezed out for a lesser price.

The U. S. Supreme Court discussed this type of statute in Voeller v Neilston Warehouse Co., 311 U. S. 531, 61 S. Ct. 376, 85 L. Ed. 322, and in speaking through Justice Black said:

"At common law, unanimous shareholder consent was a prerequisite to fundamental changes in the corporation. This made it possible for an arbitrary minority to establish a nuisance value for its shares by refusal to cooperate. To meet the situation, legislatures authorized the making of changes by a majority vote. This, however, opened the

door to victimization of the minority. To solve the dilemma, statutes permitting a dissenting minority to recover the appraised value of its shares, were widely adopted."

In Iowa prior to 1933, the statute as then worded and interpreted required the majority to purchase the dissenter's stock as a condition precedent to the issuance of a certificate of corporate renewal. In those instances where the majority was unable to finance the purchase of the minority stock, the minority was in a position to force a liquidation against the will of the majority.

In 1933, the 45th General Assembly attempted to correct this injustice by adding the following sentence:

"Stockholders voting for renewal shall have three years from the date such action for renewal was taken in which to purchase the stock voted against such renewal, which purchase price shall bear interest at eight (now five) percent per annum from the date of such renewal action until paid, * * *."

In State ex rel. Robbins v. Shellsburg Grain & Lumber Co., 243 Iowa 734, 739, 53 N. W. 2d 143, 145, we discuss this historical development saying:

"It is true * * * the object of the purchase clause in the statute is to protect a minority stockholder against roughshod tactics upon the part of a majority group." We conclude that the 1933 amendment "was enacted to protect the majority group in voting for a renewal of the corporate charter. It gave to them a three-year period of grace within which to arrange for payment of the real value of the dissenter's stock, without being harassed by judgments and executions." We do not here have a question of the issuance of a certificate of renewal or harassment by judgment or executions. We are concerned with the real value of defendant's stock and the amend-

ment did not change the basic purposes of the statute. The majority was given the right to continue the corporation in return for the payment to the minority of its fair share of the real value of the corporation. It is contrary to the purpose of the statute to discount the minority interest because it is a minority. This in effect would let the majority force the minority out without paying it its fair share of the value of the corporation.

No cases have been cited which say outright that there should be no discount because a minority interest is involved. Our attention, however, has been directed to several cases which seem to so hold, in effect. In American General Corporation v. Camp, 171 Md. 629, 190 A. 225, the Maryland court stated that the dissenting stockholder was entitled to receive "the aliquot proportion which the number of shares held would be entitled to receive in the distribution of the net amount of the corporate funds in which his particular kind of stock would be entitled to share."

In Tri-Continental Corporation v. Battye, 31 Del. Ch. 523, 74 A. 2d 71, the Delaware Court said:

"The basic concept of value under the appraisal statute is that the stockholder is entitled to be paid for that which has been taken from him, viz., his proportionate interest in a going concern. * * * The ultimate value of General's common stock, therefore, is the percentage of the fair asset value which could reasonably be expected, at some time, to have been realized by the common stockholder."

OPINION
of the
Tax Court of the United States

No. 4363-65

No. 4364-65

Fred W. Woodward and Elsie M. Woodward
Petitioners

v.

Commissioner of Internal Revenue
Respondent

F. R. Woodward and M. Jeanne Woodward
Petitioners

v.

Commissioner of Internal Revenue
Respondent

January 23, 1968

Tietjens, Judge: These consolidated cases involve deficiencies determined by respondent for the calendar year 1963 as follows:

Docket No.	Petitioners	Deficiency
4363-65	Fred W. Woodward and Elsie M. Woodward	$9,433.29
4364-65	F. R. Woodward and M. Jeanne Woodward	3,122.59

The sole issue for decision is whether fees and costs paid in connection with litigation to determine the value of certain stock represented capital expenditures or deductible expenses. In docket No. 4363-65 petitioners claim an overpayment of $1,134.47. Certain concessions of the respondent may be given effect under Rule 50.

All the facts are stipulated and are so found.

Petitioners Fred W. Woodward and Elsie M. Woodward are husband and wife. Petitioners F. R. Woodward and M. Jeanne Woodward are husband and wife. F. R. Woodward is a son of Fred W. and Elsie M. Woodward. All of the petitioners are residents of Dubuque, Iowa. Each couple filed a joint Federal income tax return for the calendar year 1963 with the district director of internal revenue at Des Moines, Iowa.

The Telegraph-Herald is a profit corporation organized under the laws of the State of Iowa, and is engaged in publishing a daily newspaper, operating a commerical printing plant and a radio station in Dubuque.

On June 9, 1960, the Telegraph-Herald had 1,200 shares of common stock issued and outstanding. Ownership of such shares on that date was as follows:

Owner	Number of Shares
Fred M. Woodward	398
F. R. Woodward	58
M. Jeanne Woodward	55
Elsie M. Woodward, R. Robert Woodward, M. Jeanne Woodward and American Trust & Savings Bank of Dubuque, Iowa, as Trustees of Fred W. Woodward Trust No. 1	200
Elsie M. Woodward, F. Robert Woodward, M. Jeanne Woodward and American Trust & Savings Bank of Dubuque, Iowa, as Trustees of Fred W. Woodward Trust No. 2	100
Charles Murphy, Executor of the Estate of Ellen Murphy, Deceased	10
Margaret M. Quigley	379
Total	1,200

The Telegraph-Herald was originally incorporated in 1901. Its corporate existence was renewed in 1921 and 1941. Under the 1941 renewal its corporate existence was extended 20 years to November 1, 1961. The common stockholders of the Telegraph-Herald held a special meeting on June 9, 1960, for the purpose of renewing and extending its corporate existence and to consider placing certain restrictions on its common stock. This meeting was attended by all of the stockholders or their representatives, at which time a resolution was duly adopted by the holders of a majority of the stock extending the corporate existence of Telegraph-Herald perpetually.

A certificate of the renewal of the Telegraph-Herald's corporate charter was issued by the Secretary of State for the State of Iowa on or about June 10, 1960.

The Telegraph-Herald's 1,200 shares of common stock issued and outstanding were all voted in favor of the renewal of the corporate existence except the 379 shares owned by Margaret M. Quigley.

Section 491.25 of the Iowa Code, Annotated, provides as follows:

491.25 Renewal—procedure

Corporations existing for a period of years may be renewed from time to time for the same or shorter periods, or may be renewed to exist perpetually, upon compliance with the provisions of this section and other applicable statutes.

The right of renewal is vested in the stockholders and shall be exercised by a resolution thereof adopted at any regular meeting or at any special meeting called for that purpose. Such resolution must be adopted by a majority of all the votes cast at such meeting, or by such other vote as is authorized or required in the company's existing articles of incorporation.

If the renewal instrument in proper form and the necessary fees are tendered to the secretary of state for filing three months or less either prior or subsequent to the corporation's expiration date, such renewal shall take effect immediately upon the expiration of the corporation's previous period of existence, and in such case, the corporate existence shall be considered as having been extended without interruption. If the renewal is filed more than three months before or after the expiration date, such renewal shall take effect upon the date such renewal with necessary fees is accepted and filed by the secretary of state; and in cases where filed more than three months after the expiration date, shall not be in legal effect a renewal unless the procedure provided for and

the additional fees provided for in section 491.28 are fully complied with and paid.

In all cases of renewal, those stockholders voting for such renewal must purchase at its real value the stock voted against such renewal, and shall have three years from the date such action for renewal was taken in which to purchase and pay for the stock voting against such renewal, which purchase price shall bear interest at the rate of five percent per annum from the date of such renewal action until paid. As amended Acts 1955 (56 G. A.) ch. 229, § 1.

The majority stockholders voting to extend the corporate existence of the Telegraph-Herald, and Margaret M. Quigley were unable to agree upon the real value of the latter's stock. The majority stockholders, with the exception of Charles Murphy, Executor of the Estate of Ellen Murphy, Deceased, on February 9, 1962, filed a Petition in Equity in the District Court of Iowa, in and for Dubuque County, asking the Court to determine and fix the real value of Margaret M. Quigley's stock. A decision was entered by the District Court on May 18, 1963, establishing a value of $1,750 per share. The District Court ordered that the costs be taxed 68% to the plaintiffs and 32% to the defendant. This decision was appealed by all parties to the Supreme Court of Iowa.

In the case of Woodward v. Quigley, 257 Iowa 1077, 133 N. W. 2d 38 (1965), the Supreme Court of Iowa determined the real value of Margaret M. Quigley's shares to be $1,650 per share. On rehearing the Supreme Court of Iowa, in Woodward v. Quigley, 257 Iowa 1077, 136 N. W. 2d 280 (1965), determined the real value to be $1,620 per share. The Supreme Court ordered that the costs be taxed one-half to the defendant and one-half to the plaintiffs.

Subsequent to the entry of final judgment in Woodward v. Quigley, *supra*, the 379 shares of Telegraph-Herald

stock owned by Margaret M. Quigley were purchased on July 16, 1965, by the majority stockholders voting to extend the corporate existence of the Telegraph-Herald, as follows:

Purchaser	Number of Shares Purchased
F. W. Woodward	184
F. R. Woodward	27
M. Jeanne Woodward	25
Trust No. 1	92
Trust No. 2	46
Estate of Ellen Murphy	5
Total	379

During the taxable year 1963 the majority stockholders voting to extend the corporate existence of the Telegraph-Herald, with the exception of Charles Murphy, Executor of the Estate of Ellen Murphy, deceased, paid attorneys', accountants' and appraisers' fees, costs and disbursements in the total amount of $37,890.75 for services rendered in connection with the determination of the real value of Margaret M. Quigley's stock as follows:

Description of Expense	Amount of Payment
Clewell, Cooney & Fuerste (Attorneys' Fees)	$17,224.14
American Appraisal Company	8,684.40
Ernst & Ernst (Accounting Fees)	5,485.00
Reporting Services	4,635.76
Miscellaneous	1,861.45
Total	$37,890.75

The proportionate share of the fees, costs and disbursements paid by Fred W. Woodward, during the taxable year 1963 was $20,072.23.

The proportionate share of the fees, costs and disbursements paid by F. R. Woodward and M. Jeanne Woodward during the taxable year 1963 was $5,931.51.

The respective petitioners claimed the above amounts as itemized deductions described as 'professional fees incurred in relation to income-producing property' on their returns for 1963.

The fees, costs and disbursements set forth above were reasonable in amount and were incurred in connection with the determination of the value of the Quigley stock, except for the amounts of $185 in the case of Fred W. and Elsie M. Woodward, and $85 in the case of F. R. and M. Jeanne Woodward, which amounts were paid for professional services in the preparation of various tax returns and are conceded to be deductible.

Respondent disallowed the deductions with the explanation that the amounts claimed "for 'Professional fees incurred in relation to income producing property' is not allowable because the fees represent capital expenditures incurred in connection with the acquisition of capital stock of a corporation, Telegraph Herald, instead of deductible expenditures."

We think respondent was clearly correct in his disallowance.

Petitioners contend that the expenses of the litigation are deductible under section 212 of the Internal Revenue Code of 1954[1] (formerly section 23 (a) (2) of the 1939

[1] **Sec. 212. Expenses for Production of Income.**

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—

(1) for the production or collection of income;

(2) for the management, conservation, or maintenance of property for the production of income; or

* * * * * * *

Code), as ordinary and necessary expenses paid for the production of income, or for the management, conservation, or maintenance of property held for the production of income.

Respondent's position based on the deficiency notice is that the litigation expenses in question were capital expenditures incurred in connection with the acquisition of capital stock and are therefore nondeductible under the provisions of section 263 of the Internal Revenue Code of 1954[2] and section 1.263 (a)-2 (c) and (e)[3] of the Regulations promulgated thereunder, as well as section 1.212-1 (k) and (n)[4] of the Regulations.

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[2] PART IX—ITEMS NOT DEDUCTIBLE

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Section 263. Capital expenditures.

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Sec. 263. Capital Expenditures.

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(a) General Rule.—No deduction shall be allowed for—

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[3] Income Tax Regulations. Section 1.263 (a)-2 Examples of capital expenditures.

The following paragraphs of this section include examples of capital expenditures:

(c) The cost of defending or perfecting title to property.

• • • • • • •

(e) Commissions paid in purchasing securities. • • •

[4] Income Tax Regulations. Section 1.212-1 Nontrade or nonbusiness expenses.

• • • • • • •

(k) Expenses paid or incurred in defending or perfecting title to property, in recovering property (other than investment property and amounts of income which, if and when recovered, must be included in gross income), or in developing or improving property, constitute a part of the cost of the property and are not deductible expenses.

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(n) Capital expenditures are not allowable as nontrade or nonbusiness expenses. The deduction of an item otherwise allowable under section 212 will not be disallowed simply because

Petitioners wanted to renew and extend the corporate existence of Telegraph-Herald. To reach this end they had to comply with the sections of the Iowa Code governing such a transaction. Those sections required petitioners in precise language to "**purchase** at its real value the stock voted against such renewal." (Emphasis supplied.) That is what they did; petitioners purchased the stock; but since they were unable to agree on its "real value" with the non-voting stockholders, they litigated that question and incurred the expenditures which they seek to deduct. The value-setting litigation and its attendant expenses were directly tied to the stock purchase and the expenses were part of the cost of the stock. As such, the expenses were clearly capital expenditures. The fact that the purchase was motivated by a desire to extend the corporate life is immaterial. **Atzingen-Whitehouse Dairy, Inc.**, 36 T. C. 173, 183 (1961).

Both parties argue extensively that the expenditures here involved were or were not made in defense or perfection of title to the stock and so were or were not capital expenditures. Petitioners also argue that the "primary purpose" of the litigation was to determine the real value of the shares of the dissenting stockholder and that title to such shares was not at issue or in dispute. These contentions are beside the point and simply cloud the real issue.

To summarize, petitioners found themselves in the position of having to buy the stock of a fellow shareholder.

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the taxpayer was entitled under subtitle A of the Code to treat such item as a capital expenditure, rather than to deduct it as an expense. For example, see section 266. Where, however, the item may properly be treated only as a capital expenditure or where it was properly so treated under an option granted in subtitle A of the Code, no deduction is allowable under section 212; and this is true regardless of whether any basis adjustment is allowed under any other provision of the Code.

Litigation was necessary to settle the price of the stock. The expenses in question were incurred in that litigation and no other. The result was the purchase of shares of stock by a group of shareholders from another shareholder at the litigated price. For all the record shows, petitioners still own the shares they purchased. Acquisition costs of property are not deductible. **John S. Lucas, et ux. v. Commissioner,** ... F. 2d ... (C. A. 1, No. 2907, 12/8/67), affirming a Memorandum Opinion of this Court. The expenditures were capital in nature to be added to the cost of the shares and are not deductible. **Atzingen-Whitehouse Dairy, Inc.,** *supra.*[5]

Reviewed by the Court.

Decisions will be entered under Rule 50.

Bruce, J., dissenting: In my opinion the majority has erred in at least three important respects in determining that the litigation expenses in question were nondeductible capital expenditures.

First, the majority, although the only issue presented in the state court litigation out of which the expenses in question arose was the "real value" of the stock owned by Margaret M. Quigley and title to such stock was not at issue or in dispute has failed to give effect to the primary purpose test which this and many other courts have recognized as controlling in the determination of the character of litigation expenses. The mere statement that such

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[5] Petitioners rely heavily on **Walter S. Heller,** 2 T. C. 371, affd. 147 F. 2d 376, on this issue, under the so-called "Dobson rule." That case involved the other side of the coin, i. e., sellers' expenses rather than purchasers' outlays. We do not think it is necessarily applicable here. If further reading is desirable see "Non-Business Expenses Relating to Property," William T. Plumb, Jr., American University Tax Institute Lectures, Vol. 2, pp. 357-360 and 4A Mertens, Law of Federal Income Taxation, sec. 25A.14, p. 40.

a question clouds the issue here presented is certainly not sufficient.

Secondly, the majority opinion is contrary to prior decisions of this and other courts, in particular, **Walter S. Heller**, 2 T. C. 371, affd. 147 F. 2d 376 (C. A. 9, 1945), certiorari denied 325 U. S. 868, and **Smith Hotel Enterprises, Inc. v. Nelson**, 236 F. Supp. 303 (D. C. Wisc., 1964), both of which involved state statutes similar to the Iowa statute involved herein. See also **Naylor v. Commissioner**, 203 F. 2d 346 (C. A. 5, 1953), reversing and remanding 17 T. C. 959. Both **Heller** and **Naylor**, *supra*, were followed by this Court in **Raymond K. Dykema**, a Memorandum Opinion dated April 28, 1953, remanded by the Court of Appeals for the Sixth Circuit only because of an inconsistency in the findings affecting a part of the expenses involved. The rationale of the **Naylor** case was also approved in a court reviewed opinion of this Court, **Otto C. Doering, Jr.**, 39 T. C. 647, 650, affirmed 335 F. 2d 738 (C. A. 2, 1964), on other grounds. Although sometimes criticized, apparently for factual reasons, neither **Heller** nor **Naylor** has ever been overruled. The distinction of the **Heller** case suggested in footnote 5 of the majority opinion is hardly a valid one. In my opinion it is immaterial whether the purchaser or the seller instituted the litigation in question. I see no reason for treating the purchaser different than the seller.

Thirdly, **Atzingen-Whitehouse Dairy, Inc.**, 36 T. C. 173, cited by the majority in support of its conclusion is clearly distinguishable on its facts. In that case there was no litigation of any character which might have required consideration of the **primary purpose test.** See **Naylor v. Commissioner**, *supra*. The only fees involved were those paid an attorney for attending conferences, preparing agreements and handling other details necessary to consummate the purchase by a corporation of the stock of two

dissident stockholders. **Lucas v. Commissioner,** ... F. 2d ... (C. A. 1, Dec. 8, 1967), cited by the majority, is also factually distinguishable from the present case.

In my opinion, the litigation expenses incurred and paid by the petitioners in connection with the case of **Woodward v. Quigley,** 257 Iowa 1077, 133 N. W. 2d 38, on rehearing 136 N. W. 2d 280 (1965), were ordinary and necessary expenses paid for the management, conservation, or maintenance of property held for the production of income and as such, are deductible under the provisions of section 212 of the Internal Revenue Code of 1954.

Petitioners contend that **Woodward v. Quigley,** *supra,* out of which the litigation expenses in question arose, was an equitable action, the primary purpose of which was to determine the "real value" of the shares of stock owned by the dissenting stockholder, Margaret M. Quigley, and that the title to such stock was not at issue or in dispute.

As a general rule, the courts have consistently recognized that expenditures made in defense or perfection of title to capital assets are capital expenditures and are not deductible as ordinary and necessary expenses whether incurred in a trade or business or in connection with a nonbusiness transaction. **Spangler v. Commissioner,** 323 F. 2d 913 (C. A. 9, 1963), affirming a Memorandum Opinion of this Court; **Robert L. Wilson,** 37 T. C. 230, affd. per curiam 313 F. 2d 636 (C. A. 5, 1963); **Industrial Aggregate Company v. United States,** 284 F. 2d 639 (C. A. 8, 1960). It has also been held that litigation or other expenses incurred in the acquisition of stock or other capital assets are capital expenditures constituting a part of the cost of property and are not deductible. See **Helvering v. Winmill,** 305 U. S. 79 (1938), involving brokers' purchase commissions; **Atzingen-Whitehouse Dairy, Inc.,** 36 T. C. 173 (1961), involving fees paid an attorney for attending conferences, preparing agreements and handling

other details necessary to consummate the purchase by the corporation of the stock of two dissident stockholders; **Iowa Southern Utilities Company v. Commissioner,** 333 F. 2d 382 (C. A. 8, 1964), certiorari denied 379 U. S. 946, affirming a Memorandum Opinion of this Court, wherein it was held that attorneys' fees and expenses incurred in a successful stockholders' derivative action and directed to be paid by the corporation were related to the recovery of capital assets and were not deductible as "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business" under section 162 (a) of the Internal Revenue Code of 1954; **Robert L. Wilson,** *supra*, which held that legal expenses paid by a widow in perfecting her dower interest in the decedent's property were capital expenditures, non-deductible under section 212 of the Internal Revenue Code of 1954.

At the same time, as was clearly pointed out by the Court of Appeals for the Eighth Circuit in **Industrial Aggregate Company v. United States,** *supra*, at p. 645, and in **Iowa Southern Utilities Company v. Commissioner,** *supra*, at pp. 385 and 386, the mere fact that title to property happens to be involved in litigation does not necessarily mean that the litigation expenses are not deductible. The test is that of primary purpose. In the **Industrial Aggregate Company** case, the Court stated:

> At the same time, ever since Kornhauser v. United States, 276 U. S. 145, 48 S. Ct. 219, 72 L. Ed. 505, cases recognize that the mere fact that title to property happens to be involved in litigation does not necessarily mean that expenditures of that litigation are automatically rendered nondeductible by the regulation. An example is Levitt & Sons v. Nunan, 2 Cir., 142 F. 2d 795, 797. Practicality and substance are to be recognized. The test which appears to have been

established is that of primary purpose. Thus, if the primary or sole purpose of the suit is to perfect or defend title, the expenditures are not deductible. Shipp v. Commissioner, 9 Cir., 217 F. 2d 401, 402; Lewis v. Commissioner, 2 Cir., 253 F. 2d 821, 827-828; Garrett v. Crenshaw, 4 Cir., 196 F. 2d 185, 187; Addison v. Commissioner, 8 Cir., supra, at page 523 of 177 F. 2d. On the other hand, even though title may be involved, if its defense or perfection is not the primary purpose of the litigation, the expenditures do not encounter the barrier of the regulation's standard and they may qualify instead as ordinary and necessary expenses. Rassenfoss v. Commissioner, 7 Cir., 158 F. 2d 764, 767-768; Sergievsky v. McNamara, D. C. S. D. N. Y., 135 F. Supp. 233, 237-238; Straub v. Granger, D. C. W. D. Pa., 143 F. Supp. 250, 254-255.[10]

[Footnotes omitted.]

See also Manufacturers Hanover Trust Co. v. United States, 312 F. 2d 785, 789 (Ct. Cl., 1963).

As was noted by the Court of Appeals for the Eighth Circuit in Industrial Aggregate Company v. United States, *supra*, in footnote 10 at page 645, the line of demarkation is not always apparent and each case is to be examined and decided on its own facts.

Under section 491.25 of the Iowa Statutes, as interpreted by the Supreme Court of Iowa in **State v. Shellsburg Grain & Lumber Co.**, 243 Iowa 734, 53 N. W. 2d 143 (1952); **Terrell v. Ringgold County Mut. Telephone Co.**, 225 Iowa 994, 282 N. W. 702 (1938); and **Melsha v. Tribune Pub. Co.**, 243 Iowa 350, 51 N. W. 2d 425 (1952), the duty of the majority stockholders to purchase the stock of the dissenting stockholder arose as of the date the vote for renewal was taken. The statute imposed no duty on the corporation, as such, to purchase the stock of the dissent-

ing stockholder, and its purchase by the majority stockholders was neither a condition precedent to the renewal of the corporate charter nor a condition subsequent to the continued existence of the corporation. The renewal of the corporate charter was effective upon the expiration of the existing charter. As held by the court in **State v. Shellsburg Grain & Lumber Co.**, *supra*, the extent and nature of the liability created by the vote for renewal of the corporate charter were matters of a purely private right between the two groups of stockholders to be determined in a proper proceeding.

The case of **Woodward v. Quigley**, *supra*, was brought to resolve such a purely private right between the majority and dissenting stockholders. The corporation was not a party thereto and the action did not involve its business operations. The stock which petitioners owned in Telegraph-Herald was held by them for investment purposes and the extension of the life of the corporation was necessary to the management, conservation, or maintenance of such property. The majority stockholders recognized their obligation under the Iowa statute to purchase the stock of the dissenting stockholder.[6] The majority stockholders were interested in minimizing the value of the stock whereas the dissenting stockholder was interested in a high valuation. Being unable to agree upon the "real value" of the stock in question, the primary, and, in fact, the only purpose of the litigation was to obtain a court determination of the real value of the

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[6] The first opinion of the Supreme Court of Iowa stated (133 N. W. 2d 38, 40):

> Plaintiffs recognize their obligation to purchase the stock under this statute, but the parties have been unable to agree on the "real value" of defendant's stock. This action was brought by the majority stockholders to secure a court determination of the "real value." The trial court established a value of $1,750 per share and both parties have appealed.

See also **Robbins v. Beatty**, 67 N. W. 2d 12 (Iowa, 1954).

stock. Neither a money judgment nor the enforcement of a contract or statutory obligation was sought or determined. Title to the stock was never in question, and was only incidentally involved.[7] Title remained in the dissenting stockholder until, on July 16, 1965, the majority stockholders purchased the shares of stock owned by the dissenting stockholder, Margaret M. Quigley. The amounts paid for such stock are not involved in this proceeding.

In my opinion the litigation expenses incurred and paid by petitioners in connection with the above-entitled action are deductible, under the provisions of section 212 of the Internal Revenue Code of 1954, in ordinary and necessary expenses paid for the production of income, or for the management, conservation, or maintenance of property held for the production of income. I would so hold.

The parties have cited three cases involving state statutes somewhat similar to the Iowa statute involved herein. Two of the cases cited by petitioners support the conclusion I have reached in this proceeding; one cited by respondent reached a different conclusion.

In **Walter S. Heller**, 2 T. C. 371, affd. 147 F. 2d 376 (C. A. 9, 1945), certiorari denied 325 U. S. 868, cited by petitioners, the issue was whether legal fees and expenses paid by a dissenting stockholder, in connection with litigation to determine the value and to enforce his rights to the cash value of his shares pursuant to a California statute providing that stockholders not consenting to a merger or consolidation were entitled to be paid such

[7] This is further emphasized by the fact that, although the Iowa statute imposed an obligation on the majority stockholders to purchase the stock of the dissenting stockholder, there is nothing in the statute or in the decisions of the Iowa courts, which would have prevented the dissenting stockholder, if she had not been satisfied with the value found by the court, from withdrawing her objection to the renewal and retaining her stock. Thus, a sale of the stock might not have taken place.

value, were deductible as expenses for the production or collection of income or in the management of property held for the production of income. This Court stated (p. 374):

> The attorneys' fee paid by petitioner, while relating to a capital asset, bore a reasonable and proximate relation to the production or collection of income, and to the management of property held for that purpose. The litigation did not, as respondent urges, involve a defense by petitioner of his rights in, and his title to, the stock. The statute under which it was instituted pre-supposes that the 'dissenting stockholders' own the shares which they are seeking to have appraised. The litigation concerned the exercise by petitioner of his right to receive cash for his shares and the determination of the amount thereof, he not having approved the contemplated merger or consolidation and having taken the other steps required by the statute. As a result of that litigation the fair market value of his stock was determined and paid to him in 1938. The attorneys' fee in our judgment was paid for services rendered in connection with "the production or collection of income," and in connection with "the management * * * of property held for the production of income." Respondent therefore erred in disallowing the claimed deduction.

In **Smith Hotel Enterprises, Inc. v. Nelson,** 236 F. Supp. 303 (D. C. Wisc., 1964) also cited by the petitioners, the corporation agreed to sell substantially all its assets, and under a Wisconsin statute was required to purchase the stock of dissenting stockholders. It paid legal and other professional expenses in litigation to determine the fair value of the shares. The District Court held the deduction of such expenses was proper as an ordinary and necessary business expense, citing **Heller,** *supra.* The Court disagreed with the contrary holding in **Boulder**

Building Corporation v. United States, 125 F. Supp. 512 (D. C. Okla., 1954), stating (at p. 305):

> Counsel for the plaintiff urges that the decision in Boulder is unsound in that it disregards the fact that the taxpayer's obligation to purchase the dissenters' stock was an involuntary obligation. Under the Oklahoma statute, as well as under the Wisconsin statute, once the dissenters have demanded that the corporation purchase their shares at fair value, the corporation has no choice in the matter. After the demand has been made, the corporation's main concern is with keeping its liability to a minimum. Plaintiff's argument is sound. Viewed in this light it appears that the primary purpose of the state litigation in the instant case was a determination of the fair value of the shares, and the involvement of title was incidental. The deduction made by the taxpayer was proper as an ordinary and necessary business expense.

In **Boulder Building Corporation v. United States,** *supra*, which is strongly relied upon by respondent, a majority of the stockholders of an Oklahoma corporation, in acordance with the provisions of an Oklahoma statute, authorized the board of directors to extend the then expiring corporate life of the company, to enlarge and amend its corporate powers and to change its name. A minority of the stockholders demanded that the corporation purchase the minority stock at fair value as provided by the statute, and, when the two factions were unable to agree on the value of the stock, filed an action in the state district court to gain a judicial determination of the stock's value. In connection with this litigation the company paid certain appraisers' and attorneys' fees, which the Commissioner disallowed as ordinary and necessary business expense deductions. The United States District Court for the Western District of Oklahoma held that such expenditures "cannot be deemed an expense

arising out of ordinary business operation but must be considered an expenditure directly related to the acquisition of capital stock."

It does not appear that the District Court was aware of, or considered the opinion of this Court (affirmed by the Ninth Circuit Court of Appeals) in the case of **Walter S. Heller**, *supra*, which reached a different conclusion on substantially analogous facts. Moreover, in my opinion, the decision in **Boulder Building Corporation** is not sound. Although stating that the "fundamental contest," the "paramount issue," the "sole question," the "fundamental issue" in the state court litigation was to determine the fair value of the stock held by the miniority stockholders, the Court stated: "It cannot reasonably be argued that title to the stock was involved only incidentally." This conclusion, in my opinion, failed to give effect to the primary purpose test and was unsound. In any event, I think the facts in the present case require a different conclusion and would so hold.

Fay, J., dissenting: I agree with much that Judge Bruce says in his dissenting opinion. I believe the facts of this case are indistinguishable from those in **Walter S. Heller**, 2 T. C. 371 (1943), affd. 147 F. 2d 376 (C. A. 9, 1945). In the opinion in that case we said, at p. 374:

> The litigation concerned the exercise by petitioner of his right to receive cash for his shares and the determination of the amount thereof, he not having approved the contemplated merger or consolidation and having taken the other steps required by the statute. As a result of that litigation the fair market value of his stock was determined and paid to him in 1938. The attorneys' fee in our judgment was paid for services rendered in connection with "the production or collection of income," and in connection

with "the management * * * of property held for the production of income." Respondent therefore erred in disallowing the claimed deduction.

The majority has not seen fit to overrule **Heller**. I think it should govern the disposition of the present case.

DECISION
of the
TAX COURT OF THE UNITED STATES

Fred W. Woodward and Elsie M. Woodward, Petitioners

v

Commissioner of Internal Revenue, Respondent

Docket No. 4363-65

Entered February 23, 1968

Pursuant to the opinion of the Court filed January 23, 1968, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

Ordered and Decided: That there is a deficiency in income tax due from the petitioners for the taxable year 1963 in the amount of $9,335.24.

Norman O. Tietjens,
Judge.

DECISION
of the
TAX COURT OF THE UNITED STATES

re

F. R. Woodward and M. Jeanne Woodward, Petitioners

v

Commissioner of Internal Revenue, Respondent

Docket No. 4364-65

Entered February 23, 1968

Pursuant to the opinion of the Court filed January 23, 1968, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

Ordered and Decided: That there is a deficiency in income tax due from the petitioners for the taxable year 1963 in the amount of $3,074.99.

Norman O. Tietjens,
Judge.

OPINION

Filed May 2, 1969
of the
UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 19,386

Fred W. Woodward and Elsie M. Woodward,
F. R. Woodward and M. Jeanne Woodward
Petitioners

v

Commissioner of Internal Revenue
Respondent

Petition for Review of the Decision of the
Tax Court of the United States

(May 2, 1969)

Before Matthes, Mehaffy and Lay, Circuit Judges

This case is before us on petition to review the decision of the Tax Court sustaining the determination by the Commissioner of Internal Revenue of deficiencies in the petitioners' income taxes for the year 1963. 49 T. C. 377 (1968) (opinion by Judge Tietjens reviewed by the entire court, with Judge Bruce and Fay dissenting).

The deficiencies result from deductions of litigation expenses incurred in connection with the acquisition of

shares of stock by the petitioners. The petitioners contend that these expenses were incurred for the conservation, management or maintenance of property held for the production of income and thus deductible under § 212 of the Internal Revenue Code of 1954 which provides:

> "In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—
>
> (1) for the production or collection of income;
>
> (2) for the management, conservation, or maintenance of property held for the production of income; . . ."

The Commissioner, on the other hand, maintains that the expenses were capital expenditures under § 263 of the 1954 Code (hereinafter referred to as "§ 263") which must be added to the basis of the property rather than deducted from gross income. Section 263 provides:

> "No deduction shall be allowed for—
>
> (1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. This paragraph shall not apply to—(exceptions, irrelevant to this case, omitted) . . .
>
> (2) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made. . . ."

Together the petitioners owned a majority interest in the Telegraph Herald, an Iowa corporation. The charter of the corporation was due to expire in 1961. The stockholders met on June 9, 1960, and by majority vote adopted a resolution extending the corporate existence of Telegraph Herald perpetually. A certificate for the renewal of the corporate charter was issued by the Secretary of the State of Iowa shortly thereafter.

The only shareholder voting against renewal was Margaret M. Quigley, who owned 379 of the 1,200 shares issued and outstanding. Under the corporate laws of Iowa it was provided that:

> "In all cases of renewal, those stockholders voting for such renewal must purchase at its real value the stock voted against such renewal, and shall have three years from the date such action for renewal was taken in which to purchase and pay for the stock voting against such renewal, which purchase price shall bear interest at the rate of five per cent per annum from the date of such renewal action until paid." Ia. Code § 491.25 (1958).

On February 9, 1962, all the majority stockholders, except one, joined in filing a petition in the District Court of Iowa, Dubuque County, seeking a determination of the real value of the Quigley stock. The value was determined by the district court to be $1,750 per share. This figure was lowered by the Supreme Court of Iowa to $1,650 per share. **Woodward v. Quigley**, 257 Ia. 1077, 133 N. W. 2d 38 (1965). On rehearing, the value was further reduced to $1,620. **Woodward v. Quigley**, 257 Ia. 1077, 1104, 136 N. W. 2d 280 (1965). After the entry of final judgment in the case, the minority stockholders, on July 16, 1965, purchased the stock.

During 1963 petitioners paid attorneys', accountants' and appraisers' fees along with other costs of services rendered in connection with the determination of the value of Mrs. Quigley's stock. The respective taxpayers deducted their proportionate shares of these expenses on their income tax returns for 1963, describing them as "professional fees incurred in relation to income-producing property." The Commissioner disallowed the deductions "because the fees represent capital expenditures incurred in connection with the acquisition of capital stock

of a corporation." The taxpayers timely filed petitions in the Tax Court for a redetermination of the deficiencies. As stated, the Tax Court upheld the Commissioner's action.

It has long been the government's view that the cost of defending or perfecting title to property is a capital expenditure. 26 C. F. R. § 1.263 (a)—2 (c) (1968).[1] The courts have accepted this view, 4A Mertens, Law of Fed. Income Taxation, §§ 25.24, 25A.16 (1966), but have added the restriction that not all expenses of litigation wherein title is involved are capital expenditures. If litigation arises concerning the title to property held by the taxpayer, the courts will look to the primary purpose of the litigation to determine the deductibility of litigation expenses.

> "Thus, if the primary or sole purpose of the suit is to perfect or defend title, the expenditures are not deductible. * * * On the other hand, even though title may be involved, if its defense or perfection is not the primary purpose of the litigation, the expenditures do not encounter the barrier of the regulation's standard and they may qualify instead as ordinary and necessary expenses. **Industrial Aggregate Co. v. United States**, 284 F. 2d 639, 645 (8th Cir. 1960) (citations omitted).

In the latter instance the expenses are currently deductible from gross income under section 162 or 212 of the Internal Revenue Code of 1954 (formerly § 23 (a) (1) and § 23 (a) (2), respectively of the Internal Revenue

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[1] 26 C. F. R., § 1.263 (a)—(2) provides:

"The following paragraphs of this section include examples of capital expenditures:

* * * * * * * *

"(c) The cost of defending or perfecting title to property."

Code of 1939 and hereinafter referred to as "§ 162" and "§ 212").[2]

Petitioners would extend the primary purpose test to litigation expenses incurred in the acquisition of property. They take the position that since the purpose of the litigation below was merely to value shares which the taxpayers were required by law to purchase—rather than to perfect, defend or acquire title—the expenditures were incurred for the management, conservation or maintenance of property held for the production of income, and thus deductible under § 212.

The Commissioner argues, and the Tax Court held, that the primary purpose doctrine has no application to litigation expenses directly connected with the acquisition of a capital asset. According to this view, that doctrine becomes operative only when, having acquired property, a taxpayer incurs expenditures to defend or perfect title thereto. Accepting this view of the matter, the Tax Court found that the "value-setting litigation and its attendant expenses were directly tied to the stock purchase and the expenses were part of the cost of the stock. As such, the

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[2] Section 162, as amended, provides:

"Trade or business expenses—(a)

In general. There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity." • • •

expenses were clearly capital expenditures," under § 263 of the 1954 Code. 49 T. C. at 382.

Petitioners' reliance on the primary purpose test is misplaced. As we have mentioned, that test developed from the uncertainty surrounding the effect of Treas. Reg. 1.263 (a)—2 (c), which gives as an example of a capital expenditure "the cost of defending or perfecting title to property." Rather, this case involves the cost of acquisition of property. We thus have no need to apply the primary purpose test, a test which would only be relevant to a situation where the taxpayer's ownership of or interest in a capital asset is challenged. This was the situation in **Industrial Aggregate Co. v. United States**, *supra*, where litigation expenses were incurred in connection with a dispute concerning leases which taxpayer had held for many years. In that case we applied the primary purpose test to find the litigation expenses deductible.

The test was also recognized in **Iowa Southern Util. Co. v. Commissioner**, 333 F. 2d 382 (8th Cir.), **cert. denied**, 379 U. S. 946 (1964). There, shareholders of the taxpayer corporation brought a derivative action against the corporations' majority shareholders and former president and others, on the theory that they had secretly acquired properties at prices for less than those at which they turned them in to the taxpayer (corporation). The corporation was not allowed to deduct the litigation expenses as ordinary and necessary business expenses under § 162. While we recognized the primary purpose test in that opinion, we did not apply the test to the facts of that case. Instead, Judge Blackmun, in reaching the decision that the litigation expenses represented capital expenditures, relied on several factors to be discussed later. Apparently the court treated the expenses as incidental to the earlier purchase of the capital assets. See **Spangler v. Commissioner**, 323 F. 2d 913, 921 (9th Cir. 1963) and

Munson v. McGinnes, 283 F. 2d 333 (3d Cir.), **cert. denied**, 364 U. S. 880 (1960).

Petitioners also suggest that they obtained equitable title to the stock on the date the shareholders voted against corporate renewal. They argue the purchase was subject only to valuation and payment of the purchase price. Based upon this premise, it is asserted that the expenses were not incurred to perfect title or to purchase and thus were not capital expenditures.

Iowa law does not support the taxpayer's premise. The only Iowa cases cited by petitioners are **Woodward v. Quigley**, *supra*; **Robbins v. Beatty**, 246 Ia. 80, 67 N. W. 2d 12 (1954); **State v. Shellsburg Grain and Lumber Co.**, 243 Ia. 734, 53 N. W. 2d 143 (1952); **Melsha v. Tribune Publishing Co.**, 243 Ia. 350, 51 N. W. 2d 425 (1952); and **Terrell v. Ringgold County Mut. Tel. Co.**, 225 Ia. 994, 282 N. W. 702 (1938). Even Judge Bruce in his dissent was unable to read into the above cases the rule espoused by the Petitioners. He stated:

> "There is nothing in the statute or in the decisions of the Iowa courts, which would have prevented the dissenting stockholder, if she had not been satisfied with the value found by the court, from withdrawing her objection to the renewal and retaining her stock. Thus, a sale of the stock might not have taken place." 49 T. C. 377, 386 at n. 2 (1968).

Assuming arguendo the validity of petitioners' premise, however, the conclusion they reach does not follow. There are several cases concerning litigation expenses incurred by the holder of equitable title of property to **perfect** his legal title. See **Spangler v. Commissioner**, *supra*, at 920, notes 16, 17. The authorities differ on whether these costs are deductible expenses or capital expenditures. **Contrast Allen v. Selig**, 200 F. 487 (5th Cir. 1952) (expenses

deductible under predecessor to § 212) **with Garrett v. Crenshaw,** 196 F. 2d 185 (4th Cir. 1952) (capital expenditures). We need not choose one of these divergent views because those cases did not concern the **acquisition** of property. Rather, the taxpayers were seeking to obtain legal recognition of their title. This purpose was not connected with the original acquisition of the property. What we have here, however, is litigation directly connected with the purchase of property. The expenses were incurred to establish the value of the capital assets acquired and were much like brokerage fees. They were part of the cost of acquisition. **Davis v. Commissioner,** 151 F. 2d 441 (8th Cir. 1945), **cert. denied,** 327 U. S. 783 (1946). And **see Johnson & Co. v. United States,** 149 F. 2d 851 (2d Cir. 1945).

This case may best be viewed against the historical background of the provision under which the deduction is claimed. Prior to the 1942 amendments to the Internal Revenue Code of 1939, expenses incurred for the production of income which could not meet the strict standards of "business" expenses were not deductible from gross income. **Higgins v. Commissioner,** 312 U. S. 212 (1941); 4A Mertens, § 25A.01 (1966). To remedy this situation Congress enacted § 23 (a) (2) of the Code.[3] Section 212 of the Internal Revenue Code of 1954, set forth above, adopted the essential provisions of § 23 (a) (2) (with additions not pertinent here).

After the passage of § 23 (a) (2) there was debate over what types of expenditures were deductible under the provision. 4A Mertens, § 25A.14, n. 55. **See** Nahstoll, Non-Trade and Non-Business Expense Deductions, 46 Mich. L.

[3] This provision allowed deductions for, "[I]n the case of an individual, all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income."

Rev. 1015, 1026 (1948). There was a feeling, which still prevails among some commentators, that the broad definition of a capital expenditure as distinguished from a business expense under §23 (a) (1), the predecessor to § 162 of the 1954 Code, was inapplicable to expenses deductible under § 23 (a) (2). Brookes, Litigation Expenses and the Income Tax, 12 Tax L. Rev. 241, 251-63 (1957); McDonald, Deduction of Attorneys' Fees for Federal Income Tax Purposes, 103 U. Pa.. L. Rev. 168, 184-89 (1954); Comment, Federal Income Tax Treatment of Attorneys' Fees, 40 Tex. L. Rev. 137, 146 (1961). However, it was determined that the two provisions were in *para materia* **Trust of Bingham v. Commissioner**, 325 U. S. 365, 373 (1945); **Iowa Southern**, *supra*, at 386; **Munson v. McGinnes**, *supra*, at 336; **see McDonald v. Commissioner**, 323 U. S. 57, 62 (1944), and the rule evolved that expenses deductible under § 212 are subject to the same limitations as § 162 expenses except for the "non-business" aspect of the former. **Trust of Bingham**, *supra*, at 374-75; **McDonald v. Commissioner**, *supra*, at 62; **Lucas v. Commissioner**, 388 F. 2d 472, 474 (1st Cir. 1967); **Iowa Southern**, *supra*, at 386; **Spangler v. Commissioner**, *supra*, at 918; 4A Mertens, § 25A.04. In particular, capital expenditures are not deductible under § 212, just as they are not deductible under § 162. **Lucas v. Commissioner**, *supra*, at 474; **Spangler v. Commissioner**, *supra*, at 918-19; **Munson v. McGinnes**, *supra*, at 335; 4A Mertens, § 25A.14.[4]

Setting aside for the moment consideration of the capital aspects of this transaction, it is difficult to comprehend how these expenses were incurred "for the management, conservation, or maintenance of property held for the production of income." What is the property conserved?

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[4] The opinions in both **Iowa Southern**, *supra*, and **Spangler v. Commissioner**, *supra*, contain excellent discussions of the history and scope of § 212.

Petitioners suggest that it was their cash; that is to say, the less money the petitioners had to pay for the stock the more money they would "conserve." This contention is wholly without substance. Section 212 was not designed to allow tax deductions for the preservation of one's net worth. To come within the scope of § 212, the petitioners are forced to argue that through the valuation proceedings they were conserving either (1) the shares of stock they held as majority shareholders, or (2) the shares of stock they were required to purchase. In our view neither theory is sound. The first is not persuasive, because under Iowa law the charter of the corporation was renewed upon affirmative action of the majority. Their interest in the corporation and the value of their shares remained unaffected. The second theory is, as we have seen, unsupported by Iowa law. Neither the statute nor the cases indicate that the petitioners became the actual owners of the stock until the purchase was consummated by payment of the value determined by the Supreme Court of Iowa.

The general rule is that expenses incurred in acquiring or disposing of property are capital expenditures. See, *e. g.*, **Lucas v. Commissioner**, *supra*, at 474; **Munson v. McGinnes**, *supra*, at 335; **Jones' Estate v. Commissioner**, 127 F. 2d 231, 232 (5th Cir. 1942). See also 4A Mertens, § 25A.15 and the cases there cited. The expenditures here fall within that category. They "related directly" to the acquisition of capital assets. **Iowa Southern**, *supra*, at 388. The property would never have been acquired had not the value been established and paid. As was stated in **Munson v. McGinnes**, *supra*, at 335, "if the problem is to reach mutually satisfactory or binding terms of sale . . . the question of capitalization must be faced." That is precisely the situation we have here. It is similar to that involved in **Ward v. Commissioner**, 224 F. 2d 547 (9th

Cir. 1955), where the seller was required to capitalize attorneys' expenses incurred in getting a higher price for the property sold. And see **Johnson & Co. v. United States**, *supra*, where litigation expenses incurred in valuing condemned property, the title to which had already passed to the purchaser, were held to be capital expenditures.

We regard our conclusion as consistent with the reasoning and result of our **Iowa Southern** decision, *supra*. There the state court action "had to do with the excess of the purchase prices paid by the taxpayer for assets transferred to it." *Id.* at 388. Here the state action concerned the amount to be paid for assets to be received. In **Iowa Southern** we recognized, "purchase prices, incontrovertibly, are capital in character. . . . What we desired in the state action was an adjustment in the prices," and thus, "the fees and expenses incurred related directly to capital." Here the state action also concerned the amount to be paid for the capital asset and was thus "related directly" to capital.

Again in **Iowa Southern** "the transferred assets were non-cash in character and were basis properties." The same is true here. And the excess amounts received by the taxpayer in **Iowa Southern** "could logically be expected to have pertinency in the adjustment of basis." Here the amount paid by the taxpayer has a logical pertinence to the adjustment of basis. In fact the amount paid, including acquisition expenses, is the basis.

Finally, we noted in **Iowa Southern that it is the** "origin **of the liability**" and "**the kind of transaction out of which the obligation arose**" that is crucial. While these phrases were originally spoken in another context, **United States v. Gilmore**, 372 U. S. 39, 47-48 (1963) and **Deputy v. DuPont**, 308 U. S. 488, 494, 496 (1940), we believe that the "kind

of transaction" is important in the determination of whether an expense is currently deductible or must be capitalized. The transaction involved here was the purchase of capital assets. The valuation of these assets was vital to the purchase, and the litigation necessary for valuation was thus an integral part of the overall transaction.

Our attention is directed by the Petitioners to several decisions involving problems similar to the one before us. It will be noted that some of these cases involve the seller's side of the transaction. While we do not express any opinion as to whether the outcome would differ were the seller involved in this case, we do recognize a distinguishing characteristic in the seller's position. Until the property is valued and the price is paid by the purchaser, the seller still owns the property. There is not the conceptual difficulty with the phrase, "property held for the production or income," that is present here.

The first case relied upon by the taxpayers is **Heller v. Commissioner**, 2 T. C. 371 (1943), **aff'd.**, 147 F. 2d 376 (9th Cir.), cer. denied, 325 U. S. 868 (1945). There the taxpayer, a dissenting shareholder, demanded the cash value of his shares rather than the stock of another corporation in a corporate acquisition. He instituted litigation pursuant to the California corporation laws for appraisal of the stock. The litigation expenses were held deductible by the seller under § 212 because they bore a reasonable and proximate relation to the production or collection of income and to the management of property held for that purpose.

In addition to involving the seller's side of the transaction, the **Heller** case was decided the year after the predecessor to § 212 was enacted and at a time when its scope was in doubt. Furthermore, the courts in reviewing

the Tax Court's decision were bound by the then-prevailing rule of **Dobson v. Commissioner**, 320 U. S. 489 (1943). **Allied Chem. Corp. v. United States**, 305 F. 2d 433, n. 3 at 443 (Ct. Cl. 1962) (dissenting opinion). We also note that **Heller** has been impliedly criticized by the Ninth Circuit, **Spangler v. Commissioner**, *supra*, at 919-20 n. 15, and that the Commissioner in his brief suggests that it "runs counter to the mainstream of relevant decisions in this area."

The case of **Naylor v. Commissioner**, 203 F. 2d 346 (5th Cir. 1953), while not involving a corporate reorganization or renewal, presents a problem analogous to the one at hand. There the taxpayer gave an option to buy shares which he held, with the price based on the net asset value of the company at a certain date. The purchaser exercised the option to purchase the shares, but a dispute arose over the valuation. The taxpayer hired an attorney to negotiate with the purchaser concerning the value of the shares. The expenses incurred in connection with the valuation were held to be deductible under what is now § 212.

Again we note that the taxpayer was the seller in the **Naylor** case. Furthermore, that case involved a completed sale of shares by which both parties were bound. And the court treated the problem as one of the collection of income under § 212, not as one involving property held for the production of income. See **Allied Chem. Corp v. United States**, *supra*, n. 3 at 443 (dissenting opinion). Moreover, it is significant that this case was also impliedly criticized in **Spangler v. Commissioner**, *supra*, n. 15 at 919-20. See **Commissioner v. Doering**, 335 F. 2d 738, 741, 743 (2d Cir. 1964); 4A Mertens, § 25A.16 n. 69.

There are two recent federal district court cases with similar fact situations which appear to suport the taxpayers' viewpoint. In **Smith Hotel Enterprises v. Nelson**,

236 F. Supp. 303 (E. D. Wisc. 1964), the majority of the stockholders of the corporate taxpayer agreed to sell the corporation's assets. The dissenting shareholders demanded the fair value of their stock as provided for by statute. Since no agreement on valuation of the shares could be reached, the minority shareholders petitioned for a determination of value by the court. Litigation expenses in connection with the valuation proceeding were held deductible under § 162 as business expenses. In **Hilton Hotels v. United States**, 285 F. Supp. 617 (N. D. Ill. 1968), **aff'd** ... F. 2d ... (Apr. 1969), the dissenting shareholders to a corporate merger had their shares valued in appraisal proceedings for purchase by the corporate taxpayer. The expenses of the purchasing corporation were held deductible under § 162 with the court placing heavy reliance on the **Smith Hotel** decision.

Both of these decisions found deductions under § 162 rather than under § 212, the provision involved here. The court in **Smith Hotel** applied the primary purpose test to reach its decision. For reasons previously given, we do not believe that test is applicable to our case. Moreover, the statute involved in **Hilton** specifically provided that upon objection to merger by a stockholder, his shares were deemed to have been required by the corporation. As we have seen, there is no such provision in the Iowa statutes regarding corporate renewal.

The better view regarding the tax consequences of the litigation expenses in these cases is expressed by the court in **Boulder Bldg. Corp. v. United States**, 125 F. Supp. 512 (W. D. Okla. 1954), on facts essentially identical to the facts in this case. In **Boulder**, minority shareholders of the taxpayer corporation objected unsuccessfully to renewal of the corporation's charter. They demanded that the corporation purchase their shares at a fair value in accordance with the statutory provision. Disagreement

over the value of the stock ensued, and the shareholders filed a suit for a declaration of the value. Expenses incurred by the corporation incident to these proceedings were sought to be deducted as business expenses under the predecessor to § 162 of the present Code. The court rejected this contention and found the expenses to be capital expenditures because they were incurred "in connection with the acquisition of stock." *Id.* at 515-16.

In summary, the transaction involved the purchase of capital assets. The valuation of those assets was vital to the purchase, and the litigation necessary for valuation was thus inextricably woven into the fabric of the overall transaction. Petitioners have the burden of clearly showing their right to the claimed deduction. **Interstate Transit Lines v. Commissioner**, 319 U. S. 590, 593 (1943); **Iowa Southern**, *supra*, at 385. They failed to discharge that burden.

The decision of the Tax Court is affirmed.

JUDGMENT
of the
United States Court of Appeals
for the Eighth Circuit

No. 19,386

Fred W. Woodward and Elsie M. Woodward,
F. R. Woodward and M. Jeanne Woodward
Petitioners
v
Commissioner of Internal Revenue
Respondent

(May 2, 1969)

Before Matthes, Mehaffy and Lay, Circuit Judges

This cause came on to be heard on the petitions to review the decision of the Tax Court of the United States entered February 23, 1968, determining that there is a deficiency in the income taxes of the petitioners for the taxable year 1963, and was argued by counsel.

On consideration whereof, it is now here ordered and adjudged by this Court that the Decision of the Tax Court of the United States in this cause be, and the same is hereby, affirmed.

And it is further ordered by this Court that the Petition to review in this cause be, and the same is hereby, dismissed.

Order entered in accordance with opinion.

Robert C. Tucker,
Clerk.

Filed May 2, 1969

In the
Supreme Court of the United States
October Term, 1969

No. 412

Fred W. Woodward and Elsie M. Woodward,
F. R. Woodward and M. Jeanne Woodward
Petitioners

v

Commissioner of Internal Revenue
Respondent

**ORDER GRANTING CERTIORARI—
FILED OCTOBER 20, 1969**

The petition herein for a writ of certiorari to the United States Court of Appeals for the Eighth Circuit is granted, and the case is placed on the summary calendar.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

Filed October 20, 1969

FILE COPY

JUL 3 1

JOHN F. DAVIS,

IN THE

SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1969.

No. 412

FRED W. WOODWARD and ELSIE M. WOODWARD, F. R. WOODWARD and M. JEANNE WOODWARD,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI

To the United States Court of Appeals for the Eighth Circuit.

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IN THE

SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1969.

No. .....

FRED W. WOODWARD and ELSIE M. WOODWARD, F. R. WOODWARD and M. JEANNE WOODWARD,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI

To the United States Court of Appeals for the Eighth Circuit.

Petitioners pray that a **Writ of Certiorari** issue to review the judgment of the United States Court of Appeals for the Eighth Circuit, entered in the above entitled case on May 2, 1969.

CITATIONS TO OPINIONS BELOW.

The opinion of the Tax Court of the United States, printed in **Appendix A** hereto, infra, p. A-1, is reported at 49 TC 377. The opinion of the Court of Appeals, printed in **Appendix B** hereto, infra, p. A-20, is reported at 410 F. 2d 313.

JURISDICTION.

The judgment of the Court of Appeals was entered on May 2, 1969. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254 (1).

QUESTION PRESENTED.

Are amounts paid by majority stockholders (Taxpayers) for attorneys', appraisers' and accountants' fees for services rendered in connection with a state court litigation, the primary purpose of which was the judicial determination of the real value of a dissenting shareholders' common stock, deductible, under the provisions of Section 212 of the Internal Revenue Code of 1954, as ordinary and necessary expenses paid for the production of income, or for the management, conservation, or maintenance of property held for the production of income?

OR

in the alternative

Are fees and costs paid by majority shareholders (Taxpayers) relative to an equitable action arising under a state appraisal statute wherein the only issue was the "real value" of the common stock owned by a dissenting shareholder—title to such stock not being at issue or in dispute—capital expenditures incurred in connection with the acquisition of the title to the stock owned by the dissenting shareholder and therefore nondeductible under the provisions of Section 263 of the Internal Revenue Code of 1954?

STATUTES INVOLVED.

The statutory provisions involved are Section 212 of the Internal Revenue Code of 1954, 26 U. S. C., Section 212, printed in **Appendid C** hereto, infra, p. A-37, and Sec-

tion 263 of the Internal Revenue Code of 1954, 26 U. S. C., Section 263, printed in **Appendix C** hereto, infra, p. A-37.

STATEMENT OF THE CASE.

The petitioners, Fred W. Woodward and Elsie M. Woodward, are husband and wife. The petitioners, F. R. Woodward and M. Jeanne Woodward, are husband and wife. All of the petitioners are residents of Dubuque, Iowa. Each couple filed a joint federal income tax return for calendar year 1963 with the District Director of Internal Revenue at Des Moines, Iowa.

The jurisdiction of the Tax Court of the United States, the court of first instance, was invoked as a result of the filing by the taxpayers, within the time permitted by Section 6213 of the Internal Revenue Code of 1954, 26 U. S. C., Section 6213, of petitions for the redetermination of their 1963 federal income tax.

The Telegraph-Herald was originally organized as a profit corporation under the laws of the State of Iowa in 1901. Its corporate existence was renewed in 1921 and in 1941 (*Appendix pp. 4 and 19). The corporation is engaged in publishing a daily newspaper, operating a commercial printing plant and operating a radio station in Dubuque, Iowa (*Appendix pp. 3 and 20).

Pursuant to the 1941 renewal of its charter the corporate existence of the Telegraph-Herald was extended for a twenty year period to November 1, 1961 (*Appendix pp. 4 and 19). Section 491.25 of the 1958 Code of Iowa, printed in Appendix F. hereto, infra, p. A-51, provides a statutory procedure for the renewal of a corporation existing for a term of years.

On May 24, 1960, at the direction of the President of the corporation, written notice was given to each of the

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* Appendix p. ... refers to Appendix filed in Court of Appeals.

common stock shareholders of the Telegraph-Herald of a special meeting of such shareholders to be held at the office of the corporation in Dubuque, Iowa on June 9, 1960, for the purpose of renewing the corporation's existence perpetually and placing certain restrictions upon the sale and transfer of its outstanding common stock (*Appendix p. 10).

The issued and outstanding common capital stock of the Telegraph-Herald, at all times pertinent, consisted of 1,200 shares of $100 par value common stock. The ownership of the shares of common stock of the Telegraph-Herald as shown by the books and records of the corporation on June 9, 1960, was as follows (*Appendix pp. 4 and 19), to-wit:

Common Stockholder	Number of Shares
Fred W. Woodward	398
F. R. Woodward	58
M. Jeanne Woodward	55
Elsie M. Woodward, F. Robert Woodward, M. Jeanne Woodward and American Trust and Savings Bank of Dubuque, Iowa, as Trustees of Fred W. Woodward Trust No. 1	200
Elsie M. Woodward, F. Robert Woodward, M. Jeanne Woodward and American Trust and Savings Bank of Dubuque, Iowa, as Trustees of Fred W. Woodward Trust No. 2	100
Charles Murphy, Executor of the Estate of Ellen Murphy, Deceased	10
Margaret M. Quigley	379
Total number of shares of the common stock of the Telegraph-Herald issued and outstanding on June 9, 1960	1,200

At the special meeting of the common stock shareholders of the corporation held on June 9, 1960, at which all

1,200 shares of the outstanding $100 par value common stock were represented, a resolution proposing perpetual existence and renewal was submitted for adoption (*Appendix p. 12).

The proposed resolution was approved and adopted at said meeting by all common stock shareholders except Margaret M. Quigley, who voted all of her 379 shares of stock against the renewal and the adoption of the resolution (*Appendix p. 15).

A certificate for the renewal of the Telegraph-Herald's corporate charter was issued by the Secretary of State for the State of Iowa, on or about June 10, 1960 (*Appendix p. 5).

The Taxpayers having voted with the majority of the Stockholders for the renewal of the corporate charter of the Telegraph-Herald on June 9, 1960, were obligated and required by the terms and conditions of Section 491.25 of the 1958 Code of Iowa to purchase the dissenting shareholder's 379 shares of the common stock of the Telegraph-Herald at its "real value" (*Appendix p. 5). This duty of the majority stockholders to purchase the stock of the dissenting stockholder arose as of the date the vote for renewal was taken, June 9, 1960 (*Appendix pp. 22 and 24). The statute imposes no duty on the corporation, as such, to purchase the stock of the dissenting stockholder, and its purchase by the majority stockholders was neither a condition precedent to the renewal of the corporate charter nor a condition subsequent to the continued existence of the corporation (*Appendix pp. 5 and 26). The renewal of the corporate charter was effective upon the expiration of the existing charter (*Appendix pp. 5 and 26).

The dissenting stockholder, Margaret M. Quigley, and the affirmative voting stockholders were unable to agree as to the real value of her Telegraph-Herald stock (*Ap-

pendix pp. 18 and 24), and on the 9th day of February, 1962, the affirmative voting stockholders, with the exception of Charles Murphy, Executor of the Estate of Ellen Murphy, Deceased, filed an equitable action (Petition, printed in Appendix G hereto, infra, p. A-53) in the District Court of Iowa in and for Dubuque County asking the Court to determine and fix the real value of the dissenting shareholders' 379 shares of the common stock of the Telegraph-Herald as of June 9, 1960, pursuant to Section 491.25 of the 1958 Code of Iowa (*Appendix p. 17). The trial Court, in a decision rendered on May 18, 1963, determined a real value of $1,750 per share, printed in Appendix H hereto, infra, p. A-56.

All parties appealed from the real value determination of the District Court of Iowa in and for Dubuque County, to the Iowa Supreme Court. In a decision filed on February 9, 1965 (*Appendix pp. 6 and 23), the Supreme Court of Iowa determined and fixed the real value of the dissenting shareholders' common stock of the Telegraph-Herald at $1,650 per share, **Woodward v. Quigley,** 257 Iowa 1077, 133 N. W. 2d 38 (1965). The affirmative voting shareholders were granted a rehearing. The Iowa Supreme Court, in a decision filed on June 30, 1965, modified its initial determination and held that the real value of such common stock was $1,620 per share, **Woodward v. Quigley,** 257 Iowa 1077, 136 N. W. 2d 280 (1965) (*Appendix p. 7).

The case of **Woodward v. Quigley** (*Apendix p. 16) was brought to determine the extent of the liability created by the vote for renewal of the corporate charter, a matter involving a purely private right between the majority and dissenting stockholders (*Appendix pp. 7, 23 and 24). The corporation was not a party thereto and the action did not involve its business operations (*Appendix pp. 16, 21 and 26). The majority stockholders recognized their obligation under the Iowa statute to

purchase the stock of the dissenting stockholder (*Appendix p. 24). Being unable to agree upon the "real value" of the stock in question, the primary, and, in fact, the only purpose of the litigation was to obtain a court determination of the real value of the stock (*Appendix pp. 18, 21 and 24). NEITHER A MONEY JUDGMENT NOR THE ENFORCEMENT OF A CONTRACT OR STATUTORY OBLIGATION WAS SOUGHT OR DETERMINED (*Appendix pp. 18, 21 and 24). Title to the stock was never in question (*Appendix pp. 3, 17, 19, 21 and 24). The Iowa appraisal statute, Section 491.25, under which the equitable action was instituted presupposes that the dissenting stockholders own the shares which the court is to evaluate (*Appendix p. 5). Legal title remained in the dissenting stockholder until, on July 16, 1965, the majority stockholders purchased the shares of stock owned by the dissenting stockholder, Margaret M. Quigley (*Appendix pp. 7 and 42).

During the taxable year 1963 the majority stockholders voting to extend the corporate existence of the Telegraph-Herald, with the exception of Charles Murphy, Executor of the Estate of Ellen Murphy, Deceased, paid attorneys', accountants' and appraisers' fees, costs and disbursements in the total of $37,890.75 for services rendered in connection with the determination of the real value of the dissenting shareholder's, Margaret M. Quigley's stock (*Appendix p. 7).

The Taxpayers, for the taxable year 1963, deducted their proportionate share of the attorneys', accountants' and appraisers' fees, costs and disbursements from their respective adjusted gross incomes, as ordinary and necessary expenses paid for the management, conservation and maintenance of property held for the production of income pursuant to Section 212 of the Internal Revenue Code of 1954 (*Appendix p. 8, **Exhibit A** and **Exhibit B**).

The Commissioner of Internal Revenue disallowed the deductions with the explanation, contained in his Notices of Deficiency, that the amounts claimed "for 'Professional fees incurred in relation to income producing property' are not allowable because the fees represent capital expenditures incurred in connection with the acquisition of capital stock of a corporation, Telegraph-Herald, instead of deductible expenditures" (*Appendix p. 33).

REASONS FOR GRANTING THE WRIT.

1. The decision of the Court below in the instant case is directly in conflict with the decision of the Seventh Court of Appeals in **Hilton Hotels Corporation v. United States**, 410 F. 2d 194 (1969), and with the decision of the Ninth Court of Appeals in **Heller v. Commissioner**, 147 F. 2d 376, Cert. denied 325 U. S. 868 (1945).

Notwithstanding that the Court below concedes that the **Hilton Hotels Corporation** case has a . . . "similar fact situation" . . . it reaches a diametrically opposed result. The only justification advanced in the opinion by the Eighth Court of Appeals for its contrary decision is that the deduction in the **Hilton Hotels Corporation** case was allowed under Section 162 of the Internal Revenue Code of 1954 while Section 212 is involved in the **Woodward** case. In essence, the Court below held that the **Hilton Hotels Corporation** case was neither applicable nor pertinent to the **Woodward** case since the deduction claimed and allowed in the **Hilton Hotels Corporation** case was taken as a trade or business expense under Section 162. This distinction was abolished by this Court in **Trust of Bingham**, 325 U. S. 365 (1945), wherein it was held that Section 23 (a) (2) of the Internal Revenue Code of 1939 (the predecessor of Section 212 of the Internal Revenue Code of 1954) is comparable and in pari materia with Section 23 (a) (1) of the Internal Revenue Code of 1939

(the predecessor of Section 162 of the Internal Revenue Code of 1954). Accordingly, the rationale advanced by the Court below to justify its decision contrary to the **Hilton Hotels Corporation** case is in conflict with this Court's **Trust of Bingham** case.

The conflict between the two Courts of Appeal is irreconcilable relative to the application of the "Primary Purpose Test" to . . . "a similar fact situation". The Eighth Court of Appeals in the **Woodward** case having refused to apply the "Primary Purpose Test" and the Seventh Court of Appeals in the **Hilton Hotels Corporation** case having applied the Primary Purpose Test to determine the deductibility of the litigation expenses.

The **Hilton Hotels Corporation** case rests upon the rationale of **Smith Hotel Enterprises, Inc. v. Nelson,** 236 F. Supp. 303 (E. D. Wis. 1964). The **Smith Hotel Enterprises, Inc.** case is founded upon the logic and authority of the **Heller** case. All three cases involved litigation costs and expenses precipitated by a state appraisal statute. In the **Hilton Hotels Corporation** case and the **Smith Hotel Enterprises, Inc.** case the taxpayers were the so-called "purchasers" of the stock and in the **Heller** case the taxpayer was the so-called "seller" of the stock. Accordingly, no distinction is made by the Seventh Court of Appeals relative to whether the taxpayer is a so-called "purchaser" or a so-called "seller" in its determination of the deductibility of litigation costs and expenses arising under a state appraisal statute. The Court in the instant case does, however, make such a distinction in dismissing the **Heller** case as not pertinent to the **Woodward** factual situation.

In addition, the decision of the Court below in the instant case conflicts in principle with the decision of the Fifth Court of Appeals in **Naylor v. C. I. R.,** 203 F. 2d (1953).

2. Clearly the question presented is of importance in the administration of the federal income tax law as well as to the business community. Settlement of this question is plainly in the public interest, since it will undoubtedly arise in every merger, consolidation and renewal of a corporation. A stockholder of a corporation contemplating such action must decide in every instance whether to go along with such merger, etc., or whether to dissent to such action. If he does not go along with the merger, etc., he has the further problem of determining whether the "buy-out" proposal of the corporation is commensurate with the "fair value" of his stock. At this stage he seeks professional counsel, relative to the "fair value" of his stock, his legal rights and remedies. Are the fees thus far incurred deductible? If he decides that the "buy-out" offer is too low and a judicial determination of value follows . . . are the litigation costs and expenses thus incurred deductible or are they to be capitalized, e. g. added to the basis of his stock? It is submitted that in the Seventh Court of Appeals that such litigation costs and expenses are deductible, but that in the Eighth Court of Appeals they are not. The Petitioners herein, the Woodwards, live in Dubuque, Iowa, a state in the Eighth Court of Appeals. Across the Mississippi River is Illinois, a state in the Seventh Court of Appeals. It is suggested that the state of the law is now such that if they had lived in Illinois at the time of the judicial determination of the real value of their Telegraph-Herald stock in 1962 they could have deducted the litigation costs and expenses thus incurred.

3. The decision of the Court below is believed to be erroneous and the conflicting decisions of the Seventh Court of Appeals in **Hilton Hotels Corporation v. United States**, supra, and the Ninth Court of Appeals in **Heller v. Commissioner**, supra, correct. The Court in the instance case refuses to consider the **Hilton Hotels Corpora-**

tion case as pertinent to and applicable to the **Woodward** case because the **Hilton Hotels Corporation** case was decided pursuant to the terms and conditions of Section 162 and not Section 212. A cursory examination of the opinion of the Eighth Court of Appeals reveals that its principal judicial authority was the case of **Boulder Building Corporation v. United States,** 125 F. Supp. 512 (W. D. Okla. 1954), notwithstanding that such case involved the deductibility of litigation costs under the predecessor of Section 162. The court in the instance case to strengthen its untenable conclusion that the litigation costs and expenses incurred in connection with a state court litigation, the primary purpose of which was the judicial determination of the real value of a dissenting shareholder's common stock, are nondeductible states that such litigation costs . . . "were much like brokerage fees". The inexactitude of this analogy is obvious; e. g. a stockbroker sells or buys stock according to the orders of his customers . . . he creates a market . . . he does not appraise the securities as to their "fair value" . . . it is his function to execute, buy and sell orders, not to make a determination of "fair value."

For pertinent comments relative to the decision in the **Woodward** case see **Stempfel v. United States,** 69-1 USTC Par. 9238 (D. C. Middle D. Tenn. 1969), and **Vermont Bank and Trust Company v. United States,** 296 F. Supp. 682 (D. C. Vt. 1969), both of which involve comparable fact situations. Further, it is strenously urged that the Court below in the instance case erred in its interpretation of the Iowa law relative to the property rights of the majority shareholders (Petitioners) and the dissenting shareholder arising on June 9, 1960 pursuant to the terms and conditions of Section 491.25 of the 1958 Code of Iowa.

The Iowa property law applicable to the factual situation existing in the instance case is as follows; to-wit:

(1). That a contract of sale arose by operation of law as a result of the action taken on June 9, 1960 at the special meeting of the stockholders;

(2). That pursuant to the terms and conditions of Section 491.25 of the 1958 Code of Iowa the statutorily imposed contract of sale became effective and binding on the majority shareholders and the dissenting shareholder on June 9, 1960; and,

(3). That whatever interest, property right, ownership, title, etc., the majority shareholders acquired in and to the dissenting shareholder's stock was acquired on June 9, 1960, subject to the payment of the purchase price.

CONCLUSION.

For the foregoing reasons, this **Petition for a Writ of Certiorari** should be granted.

Respectfully submitted,

MARTIN M. COONEY,
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Counsel for Petitioners.

APPENDIX—A.

OPINION OF THE TAX COURT OF THE UNITED STATES.

49 T. C. 377.

Filed January 23, 1968.

"Tietjens, Judge: These consolidated cases involve deficiencies determined by respondent for the calendar year 1963 as follows:

Docket No.	Petitioners	Deficiency
4363-65	Fred W. Woodward and Elsie M. Woodward	$9,433.29
4364-65	F. R. Woodward and M. Jeanne Woodward	3,122.59

The sole issue for decision is whether fees and costs paid in connection with litigation to determine the value of certain stock represented capital expenditures or deductible expenses. In docket No. 4363-65 petitioners claim an overpayment of $1,134.47. Certain concessions of the respondent may be given effect under Rule 50.

All the facts are stipulated and are so found.

Petitioners Fred W. Woodward and Elsie M. Woodward are husband and wife. Petitioners F. R. Woodward and M. Jeanne Woodward are husband and wife. F. R. Woodward is a son of Fred W. and Elsie M. Woodward. All of the petitioners are residents of Dubuque, Iowa. Each couple filed a joint Federal income tax return for the calendar year 1963 with the district director of internal revenue at Des Moines, Iowa.

The Telegraph-Herald is a profit corporation organized under the laws of the State of Iowa, and is engaged in publishing a daily newspaper, operating a commercial printing plant and a radio station in Dubuque.

On June 9, 1960, the Telegraph-Herald had 1,200 shares of common stock issued and outstanding. Ownership of such shares on that date was as follows:

Owner	Number of Shares
Fred W. Woodward	398
F. R. Woodward	58
M. Jeanne Woodward	55
Elsie M. Woodward, R. Robert Woodward, M. Jeanne Woodward and American Trust & Savings Bank of Dubuque, Iowa, as Trustees of Fred W. Woodward Trust No. 1	200
Elsie M. Woodward, F. Robert Woodward, M. Jeanne Woodward and American Trust & Savings Bank of Dubuque, Iowa, as Trustees of Fred W. Woodward Trust No. 2	100
Charles Murphy, Executor of the Estate of Ellen Murphy, Deceased	10
Margaret M. Quigley	379
Total	1,200

The Telegraph-Herald was originally incorporated in 1901. Its corporate existence was renewed in 1921 and 1941. Under the 1941 renewal its corporate existence was extended 20 years to November 1, 1961. The common stockholders of the Telegraph-Herald held a special meeting on June 9, 1960, for the purpose of renewing and extending its corporate existence and to consider placing certain restrictions on its common stock. This meeting

was attended by all of the stockholders or their representatives, at which time a resolution was duly adopted by the holders of a majority of the stock extending the corporate existence of Telegraph-Herald perpetually.

A certificate for the renewal of the Telegraph-Herald's corporate charter was issued by the Secretary of State for the State of Iowa on or about June 10, 1960.

The Telegraph-Herald's 1,200 shares of common stock issued and outstanding were all voted in favor of the renewal of the corporate existence except the 379 shares owned by Margaret M. Quigley.

Section 491.25 of the Iowa Code, Annotated, provides as follows:

491.25 Renewal—procedure

Corporations existing for a period of years may be renewed from time to time for the same or shorter periods, or may be renewed to exist perpetually, upon compliance with the provisions of this section and other applicable statutes.

The right of renewal is vested in the stockholders and shall be exercised by a resolution thereof adopted at any regular meeting or at any special meeting called for that purpose. Such resolution must be adopted by a majority of all the votes cast at such meeting, or by such other vote as is authorized or required in the company's existing articles of incorporation.

If the renewal instrument in proper form and the necessary fees are tendered to the secretary of state for filing three months or less either prior or subsequent to the corporation's expiration date, such renewal shall take effect immediately upon the expiration of the corporation's previous period of existence, and in such case, the corporate existence shall be

considered as having been extended without interruption. If the renewal is filed more than three months before or after the expiration date, such renewal shall take effect upon the date such renewal with necessary fees is accepted and filed by the secretary of state; and in cases where filed more than three months after the expiration date, shall not be in legal effect a renewal unless the procedure provided for and the additional fees provided for in section 491.28 are fully complied with and paid.

In all cases of renewal, those stockholders voting for such renewal must purchase at its real value the stock voted against such renewal, and shall have three years from the date such action for renewal was taken in which to purchase and pay for the stock voting against such renewal, which purchase price shall bear interest at the rate of five percent per annum from the date of such renewal action until paid. As amended Acts 1955 (56 G. A.) ch. 229, § 1.

The majority stockholders voting to extend the corporate existence of the Telegraph-Herald, and Margaret M. Quigley were unable to agree upon the real value of the latter's stock. The majority stockholders, with the exception of Charles Murphy, Executor of the Estate of Ellen Murphy, Deceased, on February 9, 1962, filed a Petition in Equity in the District Court of Iowa, in and for Dubuque County, asking the Court to determine and fix the real value of Margaret M. Quigley's stock. A decision was entered by the District Court on May 18, 1963, establishing a value of $1,750 per share. The District Court ordered that the costs be taxed 68% to the plaintiffs and 32% to the defendant. This decision was appealed by all parties to the Supreme Court of Iowa.

In the case of **Woodward v. Quigley**, 257 Iowa 1077, 133 N. W. 2d 28 (1965), the Supreme Court of Iowa determined

the real value of Margaret M. Quigley's shares to be $1,650 per share. On rehearing the Supreme Court of Iowa, in **Woodward v. Quigley**, 257 Iowa 1077, 136 N. W. 2d 280 (1965), determined the real value to be $1,620 per share. The Supreme Court ordered that the costs be taxed one-half to the defendant and one-half to the plaintiffs.

Subsequent to the entry of final judgment in **Woodward v. Quigley**, *supra*, the 379 shares of Telegraph-Herald stock owned by Margaret M. Quigley were purchased on July 16, 1965, by the majority stockholders voting to extend the corporate existence of the Telegraph-Herald, as follows:

Purchaser	Number of Shares Purchased
F. W. Woodward	184
F. R. Woodward	27
M. Jeanne Woodward	25
Trust No. 1	92
Trust No. 2	46
Estate of Ellen Murphy	5
Total	379

During the taxable year 1963 the majority stockholders voting to extend the corporate existence of the Telegraph-Herald, with the exception of Charles Murphy, Executor of the Estate of Ellen Murphy, deceased, paid attorneys', accountants' and appraisers' fees, costs and disbursements in the total amount of $37,890.75 for services rendered in connection with the determination of the real value of Margaret M. Quigley's stock as follows:

Description of Expense	Amount of Payment
Clewell, Cooney & Fuerste (Attorneys' Fees)	$17,224.14
American Appraisal Company	8,684.40
Ernst & Ernst (Accounting Fees)	5,485.00
Reporting Services	4,635.76
Miscellaneous	1,861.45
Total	$37,890.75

The proportionate share of the fees, costs and disbursements paid by Fred W. Woodward, during the taxable year 1963 was $20,072.23.

The proportionate share of the fees, costs and disbursements paid by F. R. Woodward and M. Jeanne Woodward during the taxable year 1963 was $5,931.51.

The respective petitioners claimed the above amounts as itemized deductions described as 'professional fees incurred in relation to income-producing property' on their returns for 1963.

The fees, costs and disbursements set forth above were reasonable in amount and were incurred in connection with the determination of the value of the Quigley stock, except for the amounts of $185 in the case of Fred W. and Elsie M. Woodward, and $85 in the case of F. R. and M. Jeanne Woodward, which amounts were paid for professional services in the preparation of various tax returns and are conceded to be deductible.

Respondent disallowed the deductions with the explanation that the amounts claimed 'for "Professional fees incurred in relation to income producing property" is not allowable because the fees represent capital expenditures incurred in connection with the acquisition of capital stock of a corporation, Telegraph Herald, instead of deductible expenditures.'

We think respondent was clearly correct in his disallowance.

Petitioners contend that the expenses of the litigation are deductible under section 212 of the Internal Revenue Code of 1954[1] (formerly section 23 (a) (2) of the 1939 Code), as ordinary and necessary expenses paid for the production of income, or for the management, conservation, or maintenance of property held for the production of income.

Respondent's position based on the deficiency notice is that the litigation expenses in question were capital expenditures incurred in connection with the acquisition of capital stock and are therefore nondeductible under the provisions of section 263 of the Internal Revenue Code of 1954[2] and section 1.263 (a)-2 (c) and (e)[3] of the Regula-

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[1] **Sec. 212. Expenses for Production of Income.**

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—

(1) for the production or collection of income;

(2) for the management, conservation, or maintenance of property for the production of income; or

* * * * * * * *

[2] PART IX—ITEMS NOT DEDUCTIBLE

* * * * * * * *

Section 263. Capital expenditures.

* * * * * * * *

Sec. 263. Capital Expenditures.

* * * * * * * *

(a) General Rule.—No deduction shall be allowed for—

* * * * * * * *

[3] Income Tax Regulations. Section 1.263 (a)-2 Examples of capital expenditures.

The following paragraphs of this section include examples of capital expenditures:

(c) The cost of defending or perfecting title to property.

* * * * * * * *

(e) Commissions paid in purchasing securities. * * *

tions promulgated thereunder, as well as section 1.212-1 (k) and (n)[4] of the Regulations.

Petitioners wanted to renew and extend the corporate existence of Telegraph-Herald. To reach this end they had to comply with the sections of the Iowa Code governing such a transaction. Those sections required petitioners in precise language to '**purchase** at its real value the stock voted against such renewal.' (Emphasis supplied.) That is what they did; petitioners purchased the stock; but since they were unable to agree on its "real value" with the non-voting stockholders, they litigated that question and incurred the expenditures which they seek to deduct. The value-setting litigation and its attendant expenses were directly tied to the stock purchase and the expenses were part of the cost of the stock. As such, the expenses were clearly capital expenditures. The fact that the purchase was motivated by a desire to extend the corporate life is immaterial. **Atzingen-Whitehouse Dairy, Inc.**, 36 T. C. 173, 183 (1961).

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[4] Income Tax Regulations. Section 1.212-1 Nontrade or nonbusiness expenses.

* * * * * * * *

(k) Expenses paid or incurred in defending or perfecting title to property, in recovering property (other than investment property and amounts of income which, if and when recovered, must be included in gross income), or in developing or improving property, constitute a part of the cost of the property and are not deductible expenses. * * *

* * * * * * * *

(n) Capital expenditures are not allowable as nontrade or nonbusiness expenses. The deduction of an item otherwise allowable under section 212 will not be disallowed simply because the taxpayer was entitled under subtitle A of the Code to treat such item as a capital expenditure, rather than to deduct it as an expense. For example, see section 266. Where, however, the item may properly be treated only as a capital expenditure or where it was properly so treated under an option granted in subtitle A of the Code, no deduction is allowable under section 212; and this is true regardless of whether any basis adjustment is allowed under any other provision of the Code.

Both parties argue extensively that the expenditures here involved were or were not made in defense or perfection of title to the stock and so were or were not capital expenditures. Petitioners also argue that the "primary purpose" of the litigation was to determine the real value of the shares of the dissenting stockholder and that title to such shares was not at issue or in dispute. These contentions are beside the point and simply cloud the real issue.

To summarize, petitioners found themselves in the position of having to buy the stock of a fellow shareholder. Litigation was necessary to settle the price of the stock. The expenses in question were incurred in that litigation and no other. The result was the purchase of shares of stock by a group of shareholders from another shareholder at the litigated price. For all the record shows, petitioners still own the shares they purchased. Acquisition costs of property are not deductible. **John S. Lucas, et ux. v. Commissioner**, ... F. 2d ... (C. A. 1, No. 2907, 12/8/67), affirming a Memorandum Opinion of this Court. The expenditures were capital in nature to be added to the cost of the shares and are not deductible. **Atzingen-Whitehouse Dairy, Inc.**, *supra*.[5]

Reviewed by the Court.

Decisions will be entered under Rule 50.

Bruce, J., dissenting: In my opinion the majority has erred in at least three important respects in determining

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[5] Petitioners rely heavily on **Walter S. Heller**, 2 T. C. 371, affd. 147 F. 2d 376, on this issue, under the so-called "Dobson rule." That case involved the other side of the coin, i. e., sellers' expenses rather than purchasers' outlays. We do not think it is necessarily applicable here. If further reading is desirable see "Non-Business Expenses Relating to Property," William T. Plumb, Jr., American University Tax Institute Lectures, Vol. 2, pp. 357-360 and 4A Mertens, Law of Federal Income Taxation, sec. 25A.14, p. 40.

that the litigation expenses in question were nondeductible capital expenditures.

First, the majority, although the only issue presented in the state court litigation out of which the expenses in question arose was the 'real value' of the stock owned by Margaret M. Quigley and title to such stock was not at issue or in dispute has failed to give effect to the **primary purpose test** which this and many other courts have recognized as controlling in the determination of the character of litigation expenses. The mere statement that such a question clouds the issue here presented is certainly not sufficient.

Secondly, the majority opinion is contrary to prior decisions of this and other courts, in particular, **Walter S. Heller**, 2 T. C. 371, affd. 147 F. 2d 376 (C. A. 9, 1945), certiorari denied 325 U. S. 868, and **Smith Hotel Enterprises, Inc. v. Nelson**, 236 F. Supp. 303 (D. C. Wisc., 1964), both of which involved state statutes similar to the Iowa statute involved herein. See also **Naylor v. Commissioner**, 203 F. 2d 346 (C. A. 5, 1953), reversing and remanding 17 T. C. 959. Both **Heller and Naylor**, *supra*, were followed by this Court in **Raymond K. Dykema**, a Memorandum Opinion dated April 28, 1953, remanded by the Court of Appeals for the Sixth Circuit only because of an inconsistency in the findings affecting a part of the expenses involved. The rationale of the **Naylor** case was also approved in a court reviewed opinion of this Court, **Otto C. Doering, Jr.**, 39 T. C. 647, 650, affirmed 335 F. 2d 738 (C. A. 2, 1964), on other grounds. Although sometimes criticized, apparently for factual reasons, neither **Heller** nor **Naylor** has ever been overruled. The distinction of the **Heller** case suggested in footnote 5 of the majority opinion is hardly a valid one. In my opinion it is immaterial whether the purchaser or the seller instituted the litigation in question. I see no reason for treating the purchaser different than the seller.

Thirdly, **Atzingen-Whitehouse Dairy, Inc.**, 36 T. C. 173, cited by the majority in support of its conclusion is clearly distinguishable on its facts. In that case there was no litigation of any character which might have required consideration of the **primary purpose test.** See **Naylor v. Commissioner,** *supra.* The only fees involved were those paid an attorney for attending conferences, preparing agreements and handling other details necessary to consummate the purchase by a corporation of the stock of two dissident stockholders. **Lucas v. Commissioner,** ... F. 2d ... (C. A. 1, Dec. 8, 1967), cited by the majority, is also factually distinguishable from the present case.

In my opinion, the litigation expenses incurred and paid by the petitioners in connection with the case of **Woodward v. Quigley,** 257 Iowa 1077, 133 N. W. 2d 38, on rehearing 136 N. W. 2d 280 (1965), were ordinary and necessary expenses paid for the management, conservation, or maintenance of property held for the production of income and as such, are deductible under the provisions of section 212 of the Internal Revenue Code of 1954.

Petitioners contend that **Woodward v. Quigley,** *supra,* out of which the litigation expenses in question arose, was an equitable action, the primary purpose of which was to determine the "real value" of the shares of stock owned by the dissenting stockholder, Margaret M. Quigley, and that the title to such stock was not at issue or in dispute.

As a general rule, the courts have consistently recognized that expenditures made in defense or perfection of title to capital assets are capital expenditures and are not deductible as ordinary and necessary expenses whether incurred in a trade or business or in connection with a nonbusiness transaction. **Spangler v. Commissioner,** 323 F. 2d 913 (C. A. 9, 1963), affirming a Memorandum Opinion of this Court; **Robert L. Wilson,** 37 T. C. 230, affd. per curiam 313 F. 2d 636 (C. A. 5, 1963); **Industrial Ag-**

gregate Company v. United States, 284 F. 2d 639 (C. A. 8, 1960). It has also been held that litigation or other expenses incurred in the acquisition of stock or other capital assets are capital expenditures constituting a part of the cost of property and are not deductible. See **Helvering v. Winmill**, 305 U. S. 79 (1938), involving brokers' purchase commissions; **Atzingen-Whitehouse Dairy, Inc.**, 36 T. C. 173 (1961), involving fees paid an attorney for attending conferences, preparing agreements and handling other details necessary to consummate the purchase by the corporation of the stock of two dissident stockholders; **Iowa Southern Utilities Company v. Commissioner**, 333 F. 2d 382 (C. A. 8, 1964), certiorari denied 379 U. S. 946, affirming a Memorandum Opinion of this Court, wherein it was held that attorneys' fees and expenses incurred in a successful stockholders' derivative action and directed to be paid by the corporation were related to the recovery of capital assets and were not deductible as "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business" under section 162 (a) of the Internal Revenue Code of 1954; **Robert L. Wilson**, *supra*, which held that legal expenses paid by a widow in perfecting her dower interest in the decedent's property were capital expenditures, non-deductible under section 212 of the Internal Revenue Code of 1954.

At the same time, as was clearly pointed out by the Court of Appeals for the Eighth Circuit in **Industrial Aggregate Company v. United States**, *supra*, at p. 645, and in **Iowa Southern Utilities Company v. Commissioner**, *supra*, at pp. 385 and 386, the mere fact that title to property happens to be involved in litigation does not necessarily mean that the litigation expenses are not deductible. The test is that of **primary purpose**. In the **Industrial Aggregate Company** case, the Court stated:

> At the same time, ever since Kornhauser v. United States, 276 U. S. 145, 48 S. Ct. 219, 72 L. Ed. 505,

cases recognize that the mere fact that title to property happens to be involved in litigation does not necessarily mean that expenditures of that litigation are automatically rendered nondeductible by the regulation. An example is Levitt & Sons v. Nunan, 2 Cir., 142 F. 2d 795, 797. Practicality and substance are to be recognized. The test which appears to have been established is that of **primary purpose.** Thus, if the primary or sole purpose of the suit is to perfect or defend title, the expenditures are not deductible, Shipp v. Commissioner, 9 Cir., 217 F. 2d 401, 402; Lewis v. Commissioner, 2 Cir., 253 F. 2d 821, 827-828; Garrett v. Crenshaw, 4 Cir., 196 F. 2d 185, 187; Addison v. Commissioner, 8 Cir., supra, at page 523 of 177 F. 2d. On the other hand, even though title may be involved, if its defense or perfection is not the primary purpose of the litigation, the expenditures do not encounter the barrier of the regulation's standard and they may qualify instead as ordinary and necessary expenses. Rassenfoss v. Commissioner, 7 Cir., 158 F. 2d 764, 767-768; Sergievsky v. McNamara, D. C. S. D. N. Y., 135 F. Supp. 233, 237-238; Straub v. Granger, D. C. W. D. Pa., 143 F. Supp. 250, 254-255.[10] [Footnotes omitted.]

See also **Manufacturers Hanover Trust Co. v. United States,** 312 F. 2d 785, 789 (Ct. Cl., 1963).

As was noted by the Court of Appeals for the Eighth Circuit in **Industrial Aggregate Company v. United States,** *supra,* in footnote 10 at page 645, the line of demarkation is not always apparent and each case is to be examined and decided on its own facts.

Under section 491.25 of the Iowa Statutes, as interpreted by the Supreme Court of Iowa in **State v. Shellsburg Grain & Lumber Co.,** 243 Iowa 734, 53 N. W. 2d 143 (1952); **Terrell v. Ringgold County Mut. Telephone Co.,**

225 Iowa 994, 282 N. W. 702 (1938); and **Melsha v. Tribune Pub. Co.**, 243 Iowa 350, 51 N. W. 2d 425 (1952), the duty of the majority stockholders to purchase the stock of the dissenting stockholder arose as of the date the vote for renewal was taken. The statute imposed no duty on the corporation, as such, to purchase the stock of the dissenting stockholder, and its purchase by the majority stockholders was neither a condition precedent to the renewal of the corporate charter nor a condition subsequent to the continued existence of the corporation. The renewal of the corporate charter was effective upon the expiration of the existing charter. As held by the court in **State v. Shellsburg Grain & Lumber Co.**, *supra*, the extent and nature of the liability created by the vote for renewal of the corporate charter were matters of a purely private right between the two groups of stockholders to be determined in a proper proceeding.

The case of **Woodward v. Quigley**, *supra*, was brought to resolve such a purely private right between the majority and dissenting stockholders. The corporation was not a party thereto and the action did not involve its business operations. The stock which petitioners owned in Telegraph-Herald was held by them for investment purposes and the extension of the life of the corporation was necessary to the management, conservation, or maintenance of such property. The majority stockholders recognized their obligation under the Iowa statute to purchase the stock of the dissenting stockholder.[6] The

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[6] The first opinion of the Supreme Court of Iowa stated (133 N. W. 2d 38, 40):

> Plaintiffs recognize their obligation to purchase the stock under this statute, but the parties have been unable to agree on the "real value" of defendant's stock. This action was brought by the majority stockholders to secure a court determination of the "real value." The trial court established a value of $1,750 per share and both parties have appealed.

See also **Robbins v. Beatty**, 67 N. W. 2d 12 (Iowa, 1954).

majority stockholders were interested in minimizing the value of the stock whereas the dissenting stockholder was interested in a high valuation. Being unable to agree upon the "real value" of the stock in question, the primary, and, in fact, the only purpose of the litigation was to obtain a court determination of the real value of the stock. Neither a money judgment nor the enforcement of a contract or statutory obligation was sought or determined. Title to the stock was never in question, and was only incidentally involved.[7] Title remained in the dissenting stockholder until, on July 16, 1965, the majority stockholders purchased the shares of stock owned by the dissenting stockholder, Margaret M. Quigley. The amounts paid for such stock are not involved in this proceeding.

In my opinion the litigation expenses incurred and paid by petitioners in connection with the above-entitled action are deductible, under the provisions of section 212 of the Internal Revenue Code of 1954, in ordinary and necessary expenses paid for the production of income, or for the management, conservation, or maintenance of property held for the production of income. I would so hold.

The parties have cited three cases involving state statutes somewhat similar to the Iowa statute involved herein. Two of the cases cited by petitioners support the conclusion I have reached in this proceeding; one cited by respondent reached a different conclusion.

In **Walter S. Heller**, 2 T. C. 371, affd. 147 F. 2d 376 (C. A. 9, 1945), certiorari denied 325 U. S. 868, cited by

[7] This is further emphasized by the fact that, although the Iowa statute imposed an obligation on the majority stockholders to purchase the stock of the dissenting stockholder, there is nothing in the statute or in the decisions of the Iowa courts, which would have prevented the dissenting stockholder, if she had not been satisfied with the value found by the court, from withdrawing her objection to the renewal and retaining her stock. Thus, a sale of the stock might not have taken place.

petitioners, the issue was whether legal fees and expenses paid by a dissenting stockholder, in connection with litigation to determine the value and to enforce his rights to the cash value of his shares pursuant to a California statute providing that stockholders not consenting to a merger or consolidation were entitled to be paid such value, were deductible as expenses for the production or collection of income or in the management of property held for the production of income. This Court stated (p. 374):

> The attorney's fee paid by petitioner, while relating to a capital asset, bore a reasonable and proximate relation to the production or collection of income, and to the management of property held for that purpose. The litigation did not, as respondent urges, involve a defense by petitioner of his rights in, and his title to, the stock. The statute under which it was instituted pre-supposes that the 'dissenting stockholders' own the shares which they are seeking to have appraised. The litigation concerned the exercise by petitioner of his right to receive cash for his shares and the determination of the amount thereof, he not having approved the contemplated merger or consolidation and having taken the other steps required by the statute. As a result of that litigation the fair market value of his stock was determined and paid to him in 1938. The attorneys' fee in our judgment was paid for services rendered in connection with "the production or collection of income," and in connection with "the management * * * of property held for the production of income." Respondent therefore erred in disallowing the claimed deduction.

In **Smith Hotel Enterprises, Inc. v. Nelson**, 236 F. Supp. 303 (D. C. Wisc., 1964), also cited by the petitioners, the corporation agreed to sell substantially all its assets, and

under a Wisconsin statute was required to purchase the stock of dissenting stockholders. It paid legal and other professional expenses in litigation to determine the fair value of the shares. The District Court held the deduction of such expenses was proper as an ordinary and necessary business expense, citing **Heller**, *supra*. The Court disagreed with the contrary holding in **Boulder Building Corporation v. United States**, 125 F. Supp. 512 (D. C. Okla., 1954), stating (at p. 305):

> Counsel for the plaintiff urges that the decision in Boulder is unsound in that it disregards the fact that the taxpayer's obligation to purchase the dissenters' stock was an involuntary obligation. Under the Oklahoma statute, as well as under the Wisconsin statute, once the dissenters have demanded that the corporation purchase their shares at fair value, the corporation has no choice in the matter. After the demand has been made, the corporation's main concern is with keeping its liablity to a minimum. Plaintiff's argument is sound. Viewed in this light it appears that the primary purpose of the state litigation in the instant case was a determination of the fair value of the shares, and the involvement of title was incidental. The deduction made by the taxpayer was proper as an ordinary and necessary business expense.

In **Boulder Building Corporation v. United States**, *supra*, which is strongly relied upon by respondent, a majority of the stockholders of an Oklahoma corporation, in accordance with the provisions of an Oklahoma statute, authorized the board of directors to extend the then expiring corporate life of the company, to enlarge and amend its corporate powers and to change its name. A minority of the stockholders demanded that the corporation purchase the minority stock at fair value as provided by the statute, and, when the two factions were

unable to agree on the value of the stock, filed an action in the state district court to gain a judicial determination of the stock's value. In connection with this litigation the company paid certain appraisers' and attorneys' fees, which the Commissioner disallowed as ordinary and necessary business expense deductions. The United States District Court for the Western District of Oklahoma held that such expenditures 'cannot be deemed an expense arising out of ordinary business operation but must be considered an expenditure directly related to the acquisition of capital stock.'

It does not appear that the District Court was aware of, or considered the opinion of this Court (affirmed by the Ninth Circuit Court of Appeals) in the case of **Walter S. Heller**, *supra*, which reached a different conclusion on substantially analogous facts. Moreover, in my opinion, the decision in **Boulder Building Corporation** is not sound. Although stating that the "fundamental contest," the "paramount issue," the "sole question," the "fundamental issue" in the state court litigation was to determine the fair value of the stock held by the minority stockholders, the Court stated: "It cannot reasonably be argued that title to the stock was involved only incidentally." This conclusion, in my opinion, failed to give effect to the **primary purpose** test and was unsound. In any event, I think the facts in the present case require a different conclusion and would so hold.

Fay, J., dissenting: I agree with much that Judge Bruce says in his dissenting opinion. I believe the facts of this case are indistinguishable from those in **Walter S. Heller**, 2 T. C. 371 (1943), affd. 147 F. 2d 376 (C. A. 9, 1945). In the opinion in that case we said, at p. 374:

> The litigation concerned the exercise by petitioner of his right to receive cash for his shares and the

determination of the amount thereof, he not having approved the contemplated merger or consolidation and having taken the other steps required by the statute. As a result of that litigation the fair market value of his stock was determined and paid to him in 1938. The attorneys' fee in our judgment was paid for services rendered in connection with "the production or collection of income," and in connection with "the management * * * of property held for the production of income." Respondent therefore erred in disallowing the claimed deduction.

The majority has not seen fit to overrule **Heller**. I think it should govern the disposition of the present case."

APPENDIX—B.

OPINION OF UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

410 F. 2d 313.

Filed May 2, 1969.

Matthes, Circuit Judge.

This case is before us on petition to review the decision of the Tax Court sustaining the determination by the Commissioner of Internal Revenue of deficiencies in the petitioners' income taxes for the year 1963. 49 T. C. 377 (1968) (opinion by Judge Tietjens reviewed by the entire court, with Judge Bruce and Fay dissenting).

The deficiencies result from deductions of litigation expenses incurred in connection with the acquisition of shares of stock by the petitioners. The petitioners contend that these expenses were incurred for the conservation, management or maintenance of property held for the production of income and thus deductible under § 212 of the Internal Revenue Code of 1954 which provides:

> "In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—
>
> (1) for the production or collection of income;
>
> (2) for the management, conservation, or maintenance of property held for the production of income; . . . ."

The Commissioner, on the other hand, maintains that the expenses were capital expenditures under § 263 of the 1954 Code (hereinafter referred to as "§ 263") which must be added to the basis of the property rather than deducted from gross income. Section 263 provides:

"No deduction shall be allowed for—

(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. This paragraph shall not apply to—(exceptions, irrelevant to this case, omitted) . . .

(2) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made . . ."

Together the petitioners owned a majority interest in the Telegraph Herald, an Iowa corporation. The charter of the corporation was due to expire in 1961. The stockholders met on June 9, 1960, and by majority vote adopted a resolution extending the corporate existence of Telegraph Herald perpetually. A certificate for the renewal of the corporate charter was issued by the Secretary of the State of Iowa shortly thereafter.

The only shareholder voting against renewal was Margaret M. Quigley, who owned 379 of the 1,200 shares issued and outstanding. Under the corporate laws of Iowa it was provided that:

"In all cases of renewal, those stockholders voting for such renewal must purchase at its real value the stock voted against such renewal, and shall have three years from the date such action for renewal was taken in which to purchase and pay for the stock voting against such renewal, which purchase price shall bear interest at the rate of five per cent per annum from the date of such renewal action until paid." Ia. Code § 491.25 (1958).

On February 9, 1962, all the majority stockholders, except one, joined in filing a petition in the District Court of Iowa, Dubuque County, seeking a determination of the real value of the Quigley stock. The value was determined

by the district court to be $1,750 per share. This figure was lowered by the Supreme Court of Iowa to $1,650 per share. **Woodward v. Quigley**, 257 Ia. 1077, 133 N. W. 2d 38 (1965). On rehearing, the value was further reduced to $1,620. **Woodward v. Quigley**, 257 Ia. 1077, 1104, 136 N. W. 2d 280 (1965). After the entry of final judgment in the case, the minority stockholders, on July 16, 1965, purchased the stock.

During 1963 petitioners paid attorneys', accountants' and appraisers' fees along with other costs of services rendered in connection with the determination of the value of Mrs. Quigley's stock. The respective taxpayers deducted their proportionate shares of these expenses on their income tax returns for 1963, describing them as "professional fees incurred in relation to income-producing property." The Commissioner disallowed the deductions "because the fees represent capital expenditures incurred in connection with the acquisition of capital stock of a corporation." The taxpayers timely filed petitions in the Tax Court for a redetermination of the deficiencies. As stated, the Tax Court upheld the Commissioner's action.

It has long been the government's view that the cost of defending or perfecting title to property is a capital expenditure. 26 C. F. R. § 1.263(a)—2(c) (1968).[1] The courts have accepted this view, 4A Mertens, Law of Fed. Income Taxation, §§ 25.24, 25A.16 (1966), but have added the restriction that not all expenses of litigation wherein title is involved are capital expenditures. If litigation arises concerning the title to property held by the tax-

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[1] 26 C. F. R., § 1.263 (a)—(2) provides:

"The following paragraphs of this section include examples of capital expenditures:

* * * * * * *

"(c) The cost of defending or perfecting title to property."

payer, the courts will look to the primary purpose of the litigation to determine the deductibility of litigation expenses.

> "Thus, if the primary or sole purpose of the suit is to perfect or defend title, the expenditures are not deductible. * * * On the other hand, even though title may be involved, if its defense or perfection is not the primary purpose of the litigation, the expenditures do not encounter the barrier of the regulation's standard and they may qualify instead as ordinary and necessary expenses. **Industrial Aggregate Co. v. United States**, 284 F. 2d 639, 645 (8th Cir. 1960) (citations omitted).

In the latter instance the expenses are currently deductible from gross income under section 162 or 212 of the Internal Revenue Code of 1954 (formerly § 23 (a) (1) and § 23 (a) (2), respectively of the Internal Revenue Code of 1939 and hereinafter referred to as "§ 162" and "§ 212").[2]

Petitioners would extend the primary purpose test to litigation expenses incurred in the **acquisition** of property. They take the position that since the purpose of the liti-

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[2] Section 162, as amended, provides:

"Trade or business expenses—(a)
In general. There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity." * * *

gation below was merely to value shares which the taxpayers were required by law to purchase—rather than to perfect, defend or acquire title—the expenditures were incurred for the management, conservation or maintenance of property held for the production of income, and thus deductible under § 212.

The Commissioner argues, and the Tax Court held, that the primary purpose doctrine has no application to litigation expenses directly connected with the acquisition of a capital asset. According to this view, that doctrine becomes operative only when, having acquired property, a taxpayer incurs expenditures to defend or perfect title thereto. Accepting this view of the matter, the Tax Court found that the "value-setting litigation and its attendant expenses were directly tied to the stock purchase and the expenses were part of the cost of the stock. As such, the expenses were clearly capital expenditures," under § 263 of the 1954 Code. 49 T. C. at 382.

Petitioners' reliance on the primary purpose test is misplaced. As we have mentinoned, that test developed from the uncertainty surrounding the effect of Treas. Reg. 1.263(a)—2(c), which gives as an example of a capital expenditure "the cost of defending or perfecting title to property." Rather, this case involves the cost of **acquisition** of property. We thus have no need to apply the primary purpose test, a test which would only be relevant to a situation where the taxpayer's ownership of or interest in a capital asset is challenged. This was the situation in **Industrial Aggregate Co. v. United States**, *supra*, where litigation expenses were incurred in connection with a dispute concerning leases which taxpayer had held for many years. In that case we applied the primary purpose test to find the litigation expenses deductible.

The test was also recognized in **Iowa Southern Util. Co. v. Commissioner**, 333 F. 2d 382 (8th Cir.), **cert. denied**, 379 U. S. 946 (1964). There, shareholders of the taxpayer

corporation brought a derivative action against the corporation's majority shareholders and former president and others, on the theory that they had secretly acquired properties at prices for less than those at which they turned them in to the taxpayer (corporation). The corporation was not allowed to deduct the litigation expenses as ordinary and necessary business expenses under § 162. While we recognized the primary purpose test in that opinion, we did not apply the test to the facts of that case. Instead, Judge Blackmun, in reaching the decision that the litigation expenses represented capital expenditures, relied on several factors to be discussed later. Apparently the court treated the expenses as incidental to the earlier purchase of the capital assets. See **Spangler v. Commissioner**, 323 F. 2d 913, 921 (9th Cir. 1963) and **Munson v. McGinnes**, 283 F. 2d 333 (3d Cir.), **cert. denied**, 364 U. S. 880 (1960).

Petitioners also suggest that they obtained equitable title to the stock on the date the shareholders voted against corporate renewal. They argue the purchase was subject only to valuation and payment of the purchase price. Based upon this premise, it is asserted that the expenses were not incurred to perfect title or to purchase and thus were not capital expenditures.

Iowa law does not support the taxpayer's premise. The only Iowa cases cited by petitioners are **Woodward v. Quigley**, *supra*; **Robbins v. Beatty**, 246 Ia. 80, 67 N. W. 2d 12 (1954); **State v. Shellsburg Grain and Lumber Co.**, 243 Ia. 734, 53 N. W. 2d 143 (1952); **Melsha v. Tribune Publishing Co.**, 243 Ia. 350, 51 N. W. 2d 425 (1952); and **Terrell v. Ringgold County Mut. Tel. Co.**, 225 Ia. 994, 282 N. W. 702 (1938). Even Judge Bruce in his dissent was unable to read into the above cases the rule espoused by the Petitioners. He stated:

> "There is nothing in the statute or in the decisions of the Iowa courts, which would have prevented the

dissenting stockholder, if she had not been satisfied with the value found by the court, from withdrawing her objection to the renewal and retaining her stock. Thus, a sale of the stock might not have taken place." 49 T. C. 377, 386 at n. 2 (1968).

Assuming arguendo the validity of petitioners' premise, however, the conclusion they reach does not follow. There are several cases concerning litigation expenses incurred by the holder of equitable title of property to **perfect** his legal title. See **Spangler v. Commissioner**, *supra*, at 920, notes 16, 17. The authorities differ on whether these costs are deductible expenses or capital expenditures. **Contrast Allen v. Selig**, 200 F. 2d 487 (5th Cir. 1952) (expenses deductible under predecessor to § 212) **with Garrett v. Crenshaw**, 196 F. 2d 185 (4th Cir. 1952) (capital expenditures). We need not choose one of these divergent views because those cases did not concern the **acquisition** of property. Rather, the taxpayers were seeking to obtain legal recognition of their title. This purpose was not connected with the original acquisition of the property. What we have here, however, is litigation directly connected with the purchase of property. The expenses were incurred to establish the value of the capital assets acquired and were much like brokerage fees. They were part of the cost of acquisition. **Davis v. Commissioner**, 151 F. 2d 441 (8th Cir. 1945), **cert. denied**, 327 U. S. 783 (1946). And **see Johnson & Co. v. United States**, 149 F. 2d 851 (2d Cir. 1945).

This case may best be viewed against the historical background of the provision under which the deduction is claimed. Prior to the 1942 amendments to the Internal Revenue Code of 1939, expenses incurred for the production of income which could not meet the strict standards of "business" expenses were not deductible from gross income. **Higgins v. Commissioner**, 312 U. S. 212 (1941); 4A Mertens, § 25A.01 (1966). To remedy this situation

Congress enacted § 23 (a) (2) of the Code.[3] Section 212 of the Internal Revenue Code of 1954, set forth above, adopted the essential provisions of § 23 (a) (2) (with additions not pertinent here).

After the passage of § 23 (a) (2) there was debate over what types of expenditures were deductible under the provision. 4A Mertens, § 25A.14, n. 55. **See** Nahstoll, Non-Trade and Non-Business Expense Deductions, 46 Mich. L. Rev. 1015, 1026 (1948). There was a feeling, which still prevails among some commentators, that the broad definition of a capital expenditure as distinguished from a business expense under § 23 (a) (1), the predecessor to § 162 of the 1954 Code, was inapplicable to expenses deductible under § 23 (a) (2). Brookes, Litigation Expenses and the Income Tax, 12 Tax L. Rev. 241, 251-63 (1957); McDonald, Deduction of Attorneys' Fees for Federal Income Tax Purposes, 103 U. Pa. L. Rev. 168, 184-89 (1954); Comment, Federal Income Tax Treatment of Attorneys' Fees, 40 Tex. L. Rev. 137, 146 (1961). However, it was determined that the two provisions were in *pari materia* **Trust of Bingham v. Commissioner**, 325 U. S. 365, 373 (1945); **Iowa Southern**, *supra*, at 386; **Munson v. McGinnes**, *supra*, at 336; **see McDonald v. Commissioner**, 323 U. S. 57, 62 (1944), and the rule evolved that expenses deductible under § 212 are subject to the same limitations as § 162 expenses except for the "non-business" aspect of the former. **Trust of Bingham**, *supra*, at 374-75; **McDonald v. Commissioner**, *supra*, at 62; **Lucas v. Commissioner**, 388 F. 2d 472, 474 (1st Cir. 1967); **Iowa Southern**, *supra*, at 386; **Spangler v. Commissioner**, *supra*, at 918; 4A Mertens, § 25A.04. In particular, capital expenditures are not deductible under § 212, just as they are not deductible under § 162. **Lucas**

[3] This provision allowed deductions for, "[I]n the case of an individual, all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income."

v. Commissioner, *supra*, at 474; **Spangler v. Commissioner**, *supra*, at 918-19; **Munson v. McGinnes**, *supra*, at 335; 4A Mertens, § 25A.14.[4]

Setting aside for the moment consideration of the capital aspects of this transaction, it is difficult to comprehend how these expenses were incurred "for the management, conservation, or maintenance of property held for the production of income." What is the property conserved? Petitioners suggest that it was their cash; that is to say, the less money the petitioners had to pay for the stock the more money they would "conserve." This contention is wholly without substance. Section 212 was not designed to allow tax deductions for the preservation of one's net worth. To come within the scope of § 212, the petitioners are forced to argue that through the valuation proceedings they were conserving either (1) the shares of stock they held as majority shareholders, or (2) the shares of stock they were required to purchase. In our view neither theory is sound. The first is not persuasive, because under Iowa law the charter of the corporation was renewed upon affirmative action of the majority. Their interest in the corporation and the value of their shares remained unaffected. The second theory is, as we have seen, unsupported by Iowa law. Neither the statute nor the cases indicate that the petitioners became the actual owners of the stock until the purchase was consummated by payment of the value determined by the Supreme Court of Iowa.

The general rule is that expenses incurred in acquiring or disposing of property are capital expenditures. See, *e. g.*, **Lucas v. Commissioner**, *supra*, at 474; **Munson v. McGinnes**, *supra*, at 335; **Jones' Estate v. Commissioner**, 127 F. 2d 231, 232 (5th Cir. 1942). See also 4A Mertens,

[4] The opinions in both **Iowa Southern**, *supra*, and **Spangler v. Commissioner**, *supra*, contain excellent discussions of the history and scope of § 212.

§ 25A.15 and the cases there cited. The expenditures here fall within that category. They "related directly" to the acquisition of capital assets. **Iowa Southern**, *supra*, at 388. The property would never have been acquired had not the value been established and paid. As was stated in **Munson v. McGinnes**, *supra*, at 335, "if the problem is to reach mutually satisfactory or binding terms of sale . . . the question of capitalization must be faced." That is precisely the situation we have here. It is similar to that involved in **Ward v. Commissioner**, 224 F. 2d 547 (9th Cir. 1955), where the seller was required to capitalize attorneys' expenses incurred in getting a higher price for the property sold. And see **Johnson & Co. v. United States**, *supra*, where litigation expenses incurred in valuing condemned property, the title to which had already passed to the purchaser, were held to be capital expenditures.

We regard our conclusion as consistent with the reasoning and result of our **Iowa Southern** decision, *supra*. There the state court action "had to do with the excess of the purchase prices paid by the taxpayer for assets transferred to it." *Id.* at 388. Here the state action concerned the amount to be paid for assets to be received. In **Iowa Southern** we recognized, "purchase prices, incontrovertibly, are capital in character. . . . What we desired in the state action was an adjustment in the prices," and thus, "the fees and expenses incurred related directly to capital." Here the state action also concerned the amount to be paid for the capital asset and was thus "related directly" to capital.

Again in **Iowa Southern** "the transferred assets were non-cash in character and were basis properties." The same is true here. And the excess amounts received by the taxpayer in **Iowa Southern** "could logically be expected to have pertinency in the adjustment of basis."

Here the amount paid by the taxpayer has a logical pertinence to the adjustment of basis. In fact the amount paid, including acquisition expenses, is the basis.

Finally, we noted in **Iowa Southern** that it is the "origin of the liability" and "the kind of transaction out of which the obligation arose" that is crucial. While these phrases were originally spoken in another context, **United States v. Gilmore**, 372 U. S. 39, 47-48 (1963) and **Deputy v. DuPont**, 308 U. S. 488, 494, 496 (1940), we believe that the "kind of transaction" is important in the determination of whether an expense is currently deductible or must be capitalized. The transaction involved here was the purchase of capital assets. The valuation of those assets was vital to the purchase, and the litigation necessary for valuation was thus an integral part of the overall transaction.

Our attention is directed by the petitioners to several decisions involving problems similar to the one before us. It will be noted that some of these cases involve the seller's side of the transaction. While we do not express any opinion as to whether the outcome would differ were the seller involved in this case, we do recognize a distinguishing characteristic in the seller's position. Until the property is valued and the price is paid by the purchaser, the seller still owns the property. There is not the conceptual difficulty with the phrase, "property **held** for the production of income," that is present here.

The first case relied upon by the taxpayers is **Heller v. Commissioner**, 2 T. C. 371 (1943) **aff'd**, 147 F. 2d 376 (9th Cir.), **cert. denied**, 325 U. S. 868 (1945). There the taxpayer, a dissenting shareholder, demanded the cash value of his shares rather than the stock of another corporation in a corporate acquisition. He instituted litigation pursuant to the California corporation laws for appraisal of the stock. The litigation expenses were held deductible

by the seller under § 212 because they bore a reasonable and proximate relation to the production or collection of income and to the management of property held for that purpose.

In addition to involving the seller's side of the transaction, the **Heller** case was decided the year after the predecessor to § 212 was enacted and at a time when its scope was in doubt. Furthermore, the courts in reviewing the Tax Court's decision were bound by the then-prevailing rule of **Dobson v. Commissioner**, 320 U. S. 489 (1943). **Allied Chem. Corp. v. United States**, 305 F. 2d 433, n. 3 at 443 (Ct. Cl. 1962) (dissenting opinion). We also note that **Heller** has been impliedly criticized by the Ninth Circuit, **Spangler v. Commissioner**, *supra*, at 919-20 n. 15, and that the Commissioner in his brief suggests that it "runs counter to the mainstream of relevant decisions in this area."

The case of **Naylor v. Commissioner**, 203 F. 2d 346 (5th Cir. 1953), while not involving a corporate reorganization or renewal, presents a problem analogous to the one at hand. There the taxpayer gave an option to buy shares which he held, with the price based on the net asset value of the company at a certain date. The purchaser exercised the option to purchase the shares, but a dispute arose over the valuation. The taxpayer hired an attorney to negotiate with the purchaser concerning the value of the shares. The expenses incurred in connection with the valuation were held to be deductible under what is now § 212.

Again we note that the taxpayer was the seller in the **Naylor** case. Furthermore, that case involved a completed sale of shares by which both parties were bound. And the court treated the problem as one of the collection of income under § 212, not as one involving property held for the production of income. See **Allied Chem. Corp. v. United States**, *supra*, n. 3 at 443 (dissenting opinion).

Moreover, it is significant that this case was also impliedly criticized in **Spangler v. Commissioner**, *supra*, n. 15 at 919-20. See **Commissioner v. Doering**, 335 F. 2d 738, 741, 743 (2d Cir. 1964); 4A Mertens, § 25A.16 n. 69.

There are two recent federal district court cases with similar fact situations which appear to support the taxpayers' viewpoint. In **Smith Hotel Enterprises v. Nelson**, 236 F. Supp. 303 (E. D. Wisc. 1964), the majority of the stockholders of the corporate taxpayer agreed to sell the corporation's assets. The dissenting shareholders demanded the fair value of their stock as provided for by statute. Since no agreement on valuation of the shares could be reached, the minority shareholders petitioned for a determination of value by the court. Litigation expenses in connection with the valuation proceeding were held deductible under § 162 as business expenses. In **Hilton Hotels v. United States**, 285 F. Supp. 617 (N. D. Ill. 1968), **aff'd** ... F. 2d ... (Apr. 1969), the dissenting shareholders to a corporate merger had their shares valued in appraisal proceedings for purchase by the corporate taxpayer. The expenses of the purchasing corporation were held deductible under § 162 with the court placing heavy reliance on the **Smith Hotel** decision.

Both of these decisions found deductions under § 162, rather than under § 212, the provision involved here. The court in **Smith Hotel** applied the primary purpose test to reach its decision. For reasons previously given, we do not believe that test is applicable to our case. Moreover, the statute involved in **Hilton** specifically provided that upon objection to merger by a stockholder, his shares were deemed to have been required by the corporation. As we have seen, there is no such provision in the Iowa statutes regarding corporate renewal.

The better view regarding the tax consequences of the litigation expenses in these cases is expressed by the court

in **Boulder Bldg. Corp. v. United States**, 125 F. Supp. 512 (W. D. Okla. 1954), on facts essentially identical to the facts in this case. In **Boulder**, minority shareholders of the taxpayer corporation objected unsuccessfully to renewal of the corporation's charter. They demanded that the corporation purchase their shares at a fair value in accordance with the statutory provision. Disagreement over the value of the stock ensued, and the shareholders filed a suit for a declaration of the value. Expenses incurred by the corporation incident to these proceedings were sought to be deducted as business expenses under the predecessor to § 162 of the present Code. The court rejected this contention and found the expenses to be capital expenditures because they were incurred "in connection with the acquisition of stock." *Id.* at 515-16.

In summary, the transaction involved the purchase of capital assets. The valuation of those assets was vital to the purchase, and the litigation necessary for valuation was thus inextricably woven into the fabric of the overall transaction. Petitioners have the burden of clearly showing their right to the claimed deduction. **Interstate Transit Lines v. Commissioner**, 319 U. S. 590, 593 (1943); **Iowa Southern**, *supra*, at 385. They failed to discharge that burden.

The decision of the Tax Court is affirmed.

APPENDIX—C.

STATUTES.

Internal Revenue Code of 1939

"Sec. 23. Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

(a) Expenses.—

(1) Trade or business expenses.—

(A) In general.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity. In the case of any sports program conducted for the benefit of the American National Red Cross, expenses described in section 22 (b) (16) (B) shall be allowable under this subparagraph only to the extent that such expenses exceed the amount ex-

cluded from gross income by section 22 (b)(16)."

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Note: Sec. 23(a)(1)(A) of 1939 IRC is comparable to Sec. 162(a) of 1954 IRC.

Internal Revenue Code of 1939

"Sec. 23 Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

(a) Expenses.—

• • • • • • • •

(2) Non-trade or non-business expenses.—In the case of an individual, all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conversation, or maintenance of property held for the production of income."

• • • • • • • •

Note: Sec. 23(a)(2) of 1939 IRC is comparable to Sec. 212 of 1954 IRC.

Internal Revenue Code of 1939

"Sec. 24. Items Not Deductible.

(a) General Rule.—In computing net income no deduction shall in any case be allowed in respect of—

• • • • • • • •

(2) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate, except expenditures for the development

of mines or deposits deductible under section 23(cc); . . ."

• • • • • • • •

Note: Sec. 24(a)(2) of 1939 IRC is comparable to Sec. 263(a)(1) and (2) of 1954 IRC.

Internal Revenue Code of 1954

"Sec. 162. Trade or Business Expenses.

(a) In General.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

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Note: Sec. 162(a) of 1954 IRC is comparable to Sec. 23(a)(1)(A) of 1939 IRC.

Internal Revenue Code of 1954.

"Sec. 212. Expenses for Production of Income.

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—

(1) for the production or collection of income;

(2) for the management, conservation, or maintenance of property held for the production of income; or

(3) in connection with the determination, collection, or refund of any tax."

Note: Sec. 212 of 1954 IRC is comparable to Sec. 23(a)(2) of 1939 IRC.

Internal Revenue Code of 1954.

"Sec. 263. Capital Expenditures.

(a) General Rule.—No deduction shall be allowed for—

(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. This paragraph shall not apply to—

(A) expenditures for the development of mines or deposits deductible under section 616,

(B) research and experimental expenditures deductible under section 174,

(C) soil and water conservation expenditures deductible under section 175,

(D) expenditures by farmers for fertilizer, etc., deductible under section 180, or

(E) expenditures by farmers for clearing land deductible under section 182.

(2) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made."

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Note: Sec. 263(a)(1) and (2) of 1954 IRC are comparable to Sec. 24(a) of 1939 IRC.

APPENDIX—D.

REGULATIONS.

Promulgated Pursuant to IRC of 1939.

"Sec. 39.24(a)-2 Capital Expenditures.

(a) Expenditures except non-depreciable mine development expenditures. Amounts paid for increasing the capital value or for making good the depreciation (for which a deduction has been made) of property are not deductible from gross income. See section 23(1). Amounts expended for securing a copyright and plates, which remain the property of the person making the payments, are investments of capital. The cost of defending or perfecting title to property constitutes a part of the cost of the property and is not a deductible expense. The amount expended for architects' services is part of the cost of the building. Commissions paid in purchasing securities are a part of the cost price of such securities. Commissions paid in selling securities are an offset against the selling price, except that in the case of dealers in securities such commissions may be treated as an ordinary and necessary business expense. Amounts to be assessed and paid under an agreement between bondholders or shareholders of a corporation to be used in a reorganization of the corporation, are investments of capital and not deductible for any purpose in returns of income. See Sec. 39.22(a)-16. An assessment paid by a shareholder of a national bank on account of his statutory liability is ordinarily not deductible but, subject to the provisions of the Internal Revenue Code, may in certain cases represent a loss. Expenses of the organization of a corporation, such as incorporation

fees, attorneys' and accountants' charges, are capital expenditures and not deductible from gross income. A holding company which guarantees dividends at a specified rate on the stock of a subsidiary corporation for the purpose of securing new capital for the subsidiary and increasing the value of its stock holdings in the subsidiary may not deduct amounts paid in carrying out this guaranty in computing its net income, but such payments may be added to the cost of its stock in the subsidiary."

* * * * * * * *

Promulgated Pursuant to IRC of 1954.

"Sec. 1.162-1 Business Expenses.

(a) In general. Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except items which are used as the basis for a deduction or a credit under provisions of law other than section 162."

* * * * * * * *

"Sec. 1.212-1. Non-Trade or Non-Business Expenses.

(a) **An expense may be deducted under section 212 only if—**

(1) **It has been paid or incurred by the taxpayer during the taxable year** (i) for the production or collection of income which, if and when realized, will be required to be included in income for Federal income tax purposes, or (ii) **for the management, conservation, or maintenance of property held for the production of such income,** or (iii) in connection with the determination, collection, or refund of any tax; and

(2) **It is an ordinary and necessary expense for any of the purposes stated in subparagraph (1) of this paragraph.**

(b) **The term 'income' for the purpose of section 212 includes not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years; and is not confined to recurring income but applies as well to gains from the disposition of property.** For example, if defaulted bonds, the interest from which if received would be includible in income, are purchased with the expectation of realizing capital gain on their resale, even though no current yield thereon is anticipated, ordinary and necessary expenses thereafter paid or incurred in connection with such bonds are deductible. Similarly, ordinary and necessary expenses paid or incurred in the management, conservation, or maintance of a building devoted to rental purposes are deductible notwithstanding that there is actually no income therefrom in the taxable year, and regardless of the manner in which or the purpose for which the property in question was acquired. **Expenses paid or incurred in managing, conserving, or maintaining property held for investment may be deductible under section 212 even though the property is not currently productive and there is no likelihood that the property will be sold at a profit or will otherwise be productive of income and even though the property is held merely to minimize a loss with respect thereto.**

* * * * * * * *

(d) **Expenses, to be deductible under section 212, must be 'ordinary and necessary'. Thus, such**

expenses must be reasonable in amount and must bear a reasonable and proximate relation to the production or collection of taxable income or to the management, conservation, or maintenance of property held for the production of income.

(e) A deduction under section 212 is subject to the restrictions and limitations in part IX (section 261 and following), subchapter B, chapter 1 of the Code, relating to items not deductible. Thus, no deduction is allowable under section 212 for any amount allocable to the production or collection of one or more classes of income which are not includible in gross income, or for any amount allocable to the management, conservation, or maintenance of property held for the production of income which is not included in gross income. See section 265. Nor does section 212 allow the deduction of any expenses which are disallowed by any of the provisions of subtitle A of the Code, even though such expenses may be paid or incurred for one of the purposes specified in section 212.

• • • • • • • •

(k) Expenses paid or incurred in defending or perfecting title to property, in recovering property (other than investment property included in gross income), or in developing or improving property, constitute a part of the cost of the property and are not deductible expenses. Attorneys' fees paid in a suit to quiet title to lands are not deductible; but if the suit is also to collect accrued rents thereon, that portion of such fees is deductible which is properly allocable to the services rendered in collecting such rents. Expenses paid or incurred in protect-

ing or asserting one's right to property of a decedent as heir or legatee, or as beneficiary under a testamentary trust, are not deductible.

* * * * * * * *

(m) An expense (not otherwise deductible) paid or incurred by an individual in determining or contesting a liability asserted against him does not become deductible by reason of the fact that property held by him for the production of income may be required to be used or sold for the purpose of satisfying such liability.

(n) Capital expenditures are not allowable as non-trade or non-business expenses. The deduction of an item otherwise allowable under section 212 will not be disallowed simply because the taxpayer was entitled under subtitle A of the Code to treat such item as a capital expenditure, rather than to deduct it as an expense. For example, see section 266. Where, however, the item may properly be treated only as a capital expenditure or where it was properly so treated under an option granted in subtitle A of the Code, no deduction is allowable under section 212; and this is true regardless of whether any basis adjustment is allowed under any other provision of the Code."

* * * * * * * *

"Sec. 1.263 (a)-2 Examples of Capital Expenditures.

The following paragraphs of this section include examples of capital expenditures:

(a) The cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property hav-

ing a useful life substantially beyond the taxable year."

* * * * * * * *

"(c) The cost of defending or perfecting title to property."

* * * * * * * *

"(e) Commissions paid in purchasing securities. Commissions paid in selling securities are an offset against the selling price, except that in the case of dealers in securities such commissions may be treated as an ordinary and necessary business expense."

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APPENDIX—E.

LEGISLATIVE HISTORY.

Revenue Act of 1942: HOUSE REPORT No. 2333, 77th Congress, 2nd Session (1942); 1942-2 C. B. 372.

At page 410 of 1942-2 C. B.:

"6. Nontrade or Nonbusiness Deductions.

The existing law allows taxpayers to deduct expenses incurred in connection with a trade or business. Due partly to the inadequacy of the statute and partly to court decisions, nontrade or nonbusiness expenses are not deductible, although nontrade or nonbusiness income is fully subject to tax. The bill corrects this inequity by allowing all of the ordinary and necessary expenses paid or incurred for the production or collection of income or for the management, conservation or mainteance of property held for the production of income. Thus, whether or not the expense is in connection with the taxpayer's trade or business, if it is expended in the pursuit of income or in connection with property held for the production of income, it is allowable."

At pages 429 and 430 of 1942-2 C. B.:

"Section 118. Nontrade or Nonbusiness Deductions.

This amendment allows a deduction for the ordinary and necessary expenses of an individual paid or incurred during the taxable year for the production and collection of income, or for the management, conservation, or maintenance of property held by the taxpayer for the production of income, whether or not such expenses are paid or incurred in carrying on a trade or business, and also allows a deduction for the exhaustion and wear and tear (including a reasonable amount for obsolescence) on property held for the production of income, whether or

not such property is used by the taxpayer in a trade or business.

For an expense to be deductible under this section, it must have been incurred either (1) for the production or collection of income, or (2) for the management, conservation, or maintenance of property held for the production of income. **Ordinary and necessary expenses so paid or incurred are deductible under section 23 (a) (2) even though they are not paid or incurred for the production or collection of income of the taxable year or for the management, conservation, or maintenance of property held for the production of such income. The term 'income' for this purpose comprehends not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years, and is not confined to recurring income but applies as well to gain from the disposition of property. Expenses incurred in managing or conserving property held for investment may be deductible under this provision even though there is no likelihood that the property will be sold at a profit or will otherwise be productive of income.** The expenses, however, of carrying on a transaction which does not constitute a trade or business of the taxpayer and is not carried on for the production of income or for the management, conservation, or maintenance of property, but which is carried on primarily as a sport, hobby, or recreation are not allowable as nontrade or nonbusiness expenses.

Expenses, to be deductible under section 23 (a) (2), must be ordinary and necessary, which rule presupposes that they must be reasonable in amount and must bear a reasonable and proximate relation to the production or collection of income, or to the management, conservation, or maintenance of property held for that purpose.

A deduction under this section is subject, except for the requirement of being incurred in connection with a trade

or business, to all the restrictions and limitations that apply in the case of the deduction under section 23 (a) (1) (A) of an expense paid or incurred in carrying on any trade or business. Section 24 (a) (5), as amended by this section, while continuing to disallow any amount allowable as a deduction, whether under section 23 (a) (2) or otherwise, which is allowable to one or more cases of tax-exempt income, other than interest, has the effect in addition of disallowing a deduction under section 23 (a) (2) for amounts allowable under that section which are allocable to tax-exempt interest.

Expenses incurred by an administrator or executor in the administration of the estate of a decedent, such, for example, as expenses in securing the processes and orders of the court having jurisdiction over the probate of an estate, or in adjusting claims against the estate, or in distributing the remaining assets to the beneficiaries, are not deductible under this section. Ordinary and necessary expenses, however, which are paid or incurred during the taxable year by an administrator or an executor for the production or collection of income which must be reported by the estate for income tax purposes, may be claimed as deductions under this section notwithstanding that deductions therefor are allowable under section 812 (b) in computing the gross estate subject to the estate tax. Accordingly, subsection (c) of this section amends section 162 to provide that no deduction shall be allowed under section 23 (a) (2) in computing the net income of the estate for amounts for which there may have been or has already been allowed a deduction under section 812 (b) in computing the net estate of the decedent. The present amendment would not allow as a deduction under section 23 (a) (2) for income tax purposes any amount which is allowable under section 812 (b) as a deduction in computing the net estate of a decedent for estate tax purposes, unless the Commissioner receives a statement, filed within the time and in the manner and

form prescribed by him, to the effect that the amount in question has not been claimed or allowed as a deduction under section 812 (b) and that the right to have such items allowed at any time as a deduction under section 812 (b) is waived.

Subsection (d) of this section amends 23 (1) of the Internal Revenue Code so as to allow, in addition to the deduction allowable under the existing law, a deduction for the exhaustion, wear and tear of property held by the taxpayer for the production of income, whether or not the property in question is used in the trade or business of the taxpayer, including a reasonable allowance for obsolescence. Except for this, the new allowance is subject to the same limitations and restrictions which have been applicable under this section prior to the present amendment.

The amendments made to the Internal Revenue Code by this section are applicable to all taxable years beginning after December 31, 1938. These amendments shall also be effective as if they were a part of the Revenue Act of 1938 or any prior Revenue Act on the date of its enactment."

Revenue Act of 1942: SENATE REPORT No. 1631, 77th Congress, 2nd Session (1942); 1942-2 C. B. 504.

At page 570 of 1942-2 C. B.:

"Section 121. Non-Trade or Non-Business Deductions.

This section is the same as section 118 of the House bill, except that subsection (c) of that section has been omitted therefrom and now appears as section 163 and a clerical amendment has been made in subsection (b). The amendment made by this section allows a deduction for the ordinary and necessary expenses of an individual paid or incurred during the taxable year for the produc-

tion and collection of income, or for the management, conservation, or maintenance of property held by the taxpayer for the production of income, whether or not such expenses are paid or incurred in carrying on a trade or business, and also allows a deduction for the exhaustion and wear and tear (including a reasonable amount for obsolescence) on property held for the production of income, whether or not such property is used by the taxpayer in a trade or business.

For an expense to be deductible under this section, it must have been incurred either (1) for the production or collection of income, or (2) **for the management, conservation, or maintenance of property held for the production of income. Ordinary and necessary expenses so paid or incurred are deductible under section 23 (a) (2) even though they are not paid or incurred for the production or collection of income of the taxable year or for the management, conservation, or maintenance of property held for the production of such income. The term 'income' for this purpose comprehends not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years, and is not confined to recurring income but applies as well to gain from the disposition of property.** Expenses incurred in managing or conserving property held for investment may be deductible under this provision even though there is no likelihood that the property will be sold at a profit or will otherwise be productive of income, and even though the property is held merely to minimize a loss with respect thereto. The expenses, however, of carrying on a transaction which does not constitute a trade or business of the taxpayer and is not carried on for the production of income or for the management, conservation, or maintenance of property, but which is carried on primarily as a sport, hobby, or recreation are not allowable as non-trade or non-business expenses.

Expenses, to be deductible under section 23 (a) (2), must be ordinary and necessary, which rule presupposes that they must be reasonable in amount and must bear a reasonable and proximate relation to the production or collection of income, or to the management, conservation, or maintenance of property held for that purpose.

A deduction under this section is subject, except for the requirement of being incurred in connection with a trade or business, to all the restrictions and limitations that apply in the case of the deduction under section 23 (a) (1) (A) of an expense paid or incurred in carrying on any trade or business. Section 24 (a) (5), as amended by this section, while continuing to disallow any amount allowable as a deduction, whether under section 23 (a) (2) or otherwise, which is allocable to one or more classes of tax-exempt income, other than interest, has the effect in addition of disallowing a deduction under section 23 (a) (2) for amounts allowable under that section which are allocable to tax-exempt interest.

Subsection (c) of this section amends section 23 (1) of the Code so as to allow, in addition to the deduction allowable under the existing law, a deduction for the exhaustion, wear, and tear of property held by the taxpayer for the production of income, whether or not the property in question is used in the trade or business of the taxpayer, including a reasonable allowance for absolescence. Except for this, the new allowance is subject to the same limitations and restrictions which have been applicable under this section prior to the present amendment.

The amendments made to the Code by this section are applicable to all taxable years beginning after December 31, 1938. These amendments shall also be effective as if they were a part of the Revenue Act of 1938 or any prior Revenue Act on the date of its enactment."

APPENDIX—F.

IOWA APPRAISAL STATUTE.

Section 491.25 of the Iowa Code Annotated provides as follows:

"491.25 Renewal—procedure

'Corporations existing for a period of years may be renewed from time to time for the same or shorter periods, or may be renewed to exist perpetually, upon compliance with the provisions of this section and other applicable statutes.

'The right of renewal is vested in the stockholders and shall be exercised by a resolution thereof adopted at any regular meeting or at any special meeting called for that purpose. Such resolution must be adopted by a majority of all the votes cast at such meeting, or by such other vote as is authorized or required in the company's existing articles of incorporation.

'If the renewal instrument in proper form and the necessary fees are tendered to the secretary of state for filing three months or less either prior or subsequent to the corporation's expiration date, such renewal shall take effect immediately upon the expiration of the corporation's previous period of existence, and in such case, the corporate existence shall be considered as having been extended without interruption. If the renewal is filed more than three months before or after the expiration date, such renewal shall take effect upon the date such renewal with necessary fees is accepted and filed by the secretary of state; and in cases where filed more than three months after the expiration date, shall not be in legal effect a renewal unless the procedure provided for and the

additional fees provided for in section 491.28 are fully complied with and paid.

'In all cases of renewal, those stockholders voting for such renewal must purchase at its real value the stock voted against such renewal, and shall have three years from the date such action for renewal was taken in which to purchase and pay for the stock voting against such renewal, which purchase price shall bear interest at the rate of five percent per annum from the date of such renewal action until paid. As amended Acts 1955 (56 G. A.) ch. 229, § 1.' "

APPENDIX—G.

"In the District Court of Iowa in and for Dubuque County.

F. W. Woodward, F. R. Woodward, M. Jeanne Woodward; and Elsie M. Woodward, F. Robert Woodward, M. Jeanne Woodward and American Trust & Savings Bank, Dubuque, Iowa, Trustees of Fred W. Woodward Trust No. 1; and Elsie M. Woodward, F. Robert Woodward, M. Jeanne Woodward and American Trust & Savings Bank, Dubuque, Iowa, Trustees of Fred W. Woodward Trust No. 2,

Plaintiffs,

v.

Margaret M. Quigley,

Defendant.

No. 80,257.

PETITION IN EQUITY.

Plaintiffs state:

Par. 1. That the Plaintiffs, F. W. Woodward, F. R. Woodward and M. Jeanne Woodward, are the owners of capital stock of Telegraph-Herald, an Iowa corporation, with its principal place of business in the City of Dubuque, Dubuque County Iowa, that the Plaintiffs, Elsie M. Woodward, F. Robert Woodward, M. Jeanne Woodward and American Trust & Savings Bank, Dubuque, Iowa, an Iowa corporation, as Trustees of the Fred W. Woodward Trust No. 1, are the owners of

capital stock of said corporation; that the Plaintiffs, Elsie M. Woodward, F. Robert Woodward, M. Jeanne Woodward and American Trust & Savings Bank, Dubuque, Iowa, an Iowa corporation, as Trustees of the Fred W. Woodward Trust No. 2, are the owners of capital stock of said corporation.

That each and all of said Plaintiffs are residents of Dubuque County, Iowa.

Par. 2. That the Defendant Margaret M. Quigley is a resident of Dubuque County, Iowa, and an owner of capital stock in said corporation.

Par. 3. That as of June 9, 1960, the Plaintiffs and the Defendant were the owners of all of the outstanding capital stock of said corporation except for ten shares owned by the Estate of Ellen E. Murphy, deceased, of which Charles J. Murphy was the duly appointed, qualified and acting Executor.

Par. 4. That a special meeting of the stockholders of the corporation was held at its office in the City of Dubuque, Iowa, on June 9, 1960 at 10:00 o'clock A. M., due notice of which meeting had been given to all holders of capital stock of the corporation.

That all of the capital stockholders were present or represented at said meeting.

Par. 5. At said special meeting of the stockholders of said corporation a resolution was duly adopted by a vote of the majority of all of the outstanding capital stock of said corporation, renewing and extending perpetually its corporate existence.

Par. 6. That all of the capital stockholders except the Defendant voted to renew the Articles of Incorporation and the Defendant voted against renewal.

Par. 7. That Section 491.25 of the 1958 Code of Iowa provides as follows:

> 'In all cases of renewal, those stockholders voting for such renewal must purchase at its real value the stock voted against such renewal, and shall have three years from the date such action for renewal was taken in which to purchase and pay for the stock voting against such renewal, which purchase price shall bear interest at the rate of five percent per annum from the date of such renewal action until paid.'

Par. 8. That the Plaintiffs and Defendant have been unable to agree as to the real value of the Defendant's stock as of June 9, 1960, the day the renewal resolution was adopted.

Wherefore, Plaintiffs ask that the Court determine and fix the real value of the Defendant's Telegraph-Herald capital stock as of June 9, 1960, for costs and for such other and further relief as shall be just and equitable.

ROBT. W. CLEWELL and
M. M. COONEY,
Members of the Firm of
Clewell, Cooney & Fuerste,
705 Roshek Building,
Dubuque, Iowa,
Attorneys for Plaintiffs".

APPENDIX—H.

"In the District Court of Iowa in and for Dubuque County.

F. W. Woodward et al.
vs.
Margaret M. Quigley.
} Equity No. 80257.

FINDINGS OF FACT, CONCLUSIONS OF LAW AND DECREE FIXING 'REAL VALUE.'

This case came on for trial on September 17th, 1962, the plaintiffs appearing by M. M. Cooney and Donald Cooney of the firm of Clewell, Cooney & Fuerste, and the defendant appearing by Francis J. O'Connor and E. Marshall Thomas of the firm of O'Connor, Thomas, McDermott & Wright, and the submission of evidence was completed on the 26th day of October 1962, Counsel having filed written briefs and arguments and the Court having heard oral arguments of counsel on April 30th and May 1st, 1963, and the Court now being fully advised hereby makes the following Findings of Fact, Conclusions of Law and Decree Fixing the 'Real Value' of defendant's stock of Telegraph-Herald as of June 9, 1960, as follows:

Findings of Fact.

1. Telegraph-Herald is an Iowa profit corporation and was originally incorporated in 1901. Its corporate existence was renewed in 1921 and 1941, and under the 1941 renewal its corporate existence was extended 20 years to November 1, 1961.

2. On June 9, 1960, the outstanding capital stock of Telegraph-Herald consisted of 1,200 shares of $100 par value common stock, which stock was owned by the following persons:

F. W. Woodward .....398 Shares
F. R. Woodward ..... 58 Shares
M. Jeanne Woodward ..... 55 Shares
Elsie M. Woodward, F. Robert Woodward M. Jeanne Woodward, and American Trust & Savings Bank, Dubuque, Iowa, Trustees of Fred W. Woodward Trust No. 1 .....200 Shares
Elsie M. Woodward, F. Robert Woodward M. Jeanne Woodward and American Trust & Savings Bank, Dubuque, Iowa, Trustees of Woodward Trust No. 2 ....100 Shares
Ellen Murphy, deceased, Charles J. Murphy, Executor ..... 10 Shares
Margaret M. Quigley, defendant .....379 Shares

3. At a special meeting of the stockholders of Telegraph-Herald, held on June 9, 1960, the Articles of Incorporation of Telegraph-Herald were amended to provide, among other matters, perpetual existence for said corporation. All of the outstanding stock of Telegraph-Herald was represented at such meeting in person or by proxy and was voted in favor of said amendments, except the 379 shares, owned by the defendant, Margaret M. Quigley, which were voted against the renewal of corporate existence.

4. On June 9, 1960, and for many years prior thereto, Telegraph-Herald owned and published the "Telegraph-Herald," a daily newspaper, published six days a week, Monday through Friday and on Sunday, and owned and operated radio station KDTH in Dubuque, Iowa, operating on AM frequency with 1 kilowatt power. On June 9, 1960, the Telegraph-Herald corporation was also the owner of all the oustanding common stock, consisting of 100 shares of $100 par value, of Visual Education Center, Inc., which was engaged in selling educational filmstrips and other educational material for publication in newspapers.

5. The plaintiffs are the persons listed in Findings of Fact No. 2, except the owners of the Murphy stock and the defendant, Margaret M. Quigley.

6. Plaintiff F. W. Woodward is and was at all times relevant hereto the President and Publisher of Telegraph-Herald. Plaintiff F. R. Woodward is the son of F. W. Woodward and is and was at all times relevant hereto the Secretary and Treasurer and General Manager of Telegraph-Herald. Plaintiff M. Jeanne Woodward is the wife of F. R. Woodward and plaintiff Elsie M. Woodward is the wife of F. W. Woodward. M. R. Kane is and was at all times relevant hereto the Vice President of Telegraph-Herald.

7. The Board of Directors of Telegraph-Herald in 1960 and for many years prior thereto was as follows: F. W. Woodward, F. R. Woodward, M. Jeanne Woodward, Elsie M. Woodward and M. R. Kane.

8. The defendant Margaret M. Quigley has never been an officer or director of Telegraph-Herald.

9. Margaret M. Quigley acquired her 379 shares of stock of Telegraph-Herald by bequest from her husband, Joseph C. Quigley, who died January 22, 1952.

10. On June 9, 1960, and for many years prior thereto the Telegraph-Herald newspaper was the only daily newspaper published in the City of Dubuque, or in the County of Dubuque, Iowa."

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"Conclusions of Law.

1. The Court has jurisdiction of the parties and the subject matter hereof.

2. This is an equitable proceeding to fix and determine the real value of defendant's 379 shares of stock in the

Telegraph-Herald corporation as of June 9, 1960, under section 491.25 Code of Iowa, said stock having been voted against renewal of the corporate charter on said date.

3. That plaintiffs (together with owner of 10 shares of Murphy stock) voted for the renewal of the corporate charter of Telegraph-Herald on June 9, 1960 and have the obligation to purchase defendant's 379 shares of stock of Telegraph-Herald at its 'real value' under Section 491.25 Code of Iowa plus interest thereon at the rate of 5% per annum from June 9, 1960 until paid.

4. 'Real Value' as used in Section 491.25 of the Code of Iowa, does not mean market value of the minority interest.

Robbins v. Beatty, 246 Iowa 80, 67 N. W. 2d 12 (1954).

Note: The authorities in other jurisdictions generally agree that the terms 'value,' 'actual value,' 'true,' 'fair' or 'real' value of minority stock in merger or consolidation cases do not mean market value of the minority interest.

Tri-Continental Corp. v. Battye, Del. Ch. 74 A. (2d) 71;
American General Corporation v. Camp, 171 Md. 629;
In Re Fulton, 257 N. Y. 487, 178 N. E. 766 (1921);
Petry v. Harwood Electric Co., 280 Pa. 142, 124 Atl. 302 (1924);
Republic Finance & Investment Company v. Fenster-Maker, 211 Ind. 251, 6 N. E. (2d) 541 (1937);
Roessler v. Security Savings & Loan Co., 72 N. E. (2d) 259 (1947).

5. 'Real Value' as used in Section 492.25 of the Code of Iowa, means intrinsic value, determined from a consideration of every relevant factor bearing upon the question of value.

6. In determining real value under Section 491.25 Code of Iowa, no reduction should be made on account of brokerage fees, flotation costs, or lack of marketability.

7. The real value of the 379 shares of stock of the Telegraph-Herald owned by defendant Margaret M. Quigley as of June 9, 1960, was $1,750.00 per share, or a total of $663,250.00.

8. The costs of this case are taxed to the parties as follows: 68% to plaintiffs and 32% to defendant.

Decree.

It is, therefore, Ordered, Adjudged and Decreed that the 'real value' of the 379 shares of common capital stock of Telegraph-Herald owned by the defendant, Margaret M. Quigley as of June 9, 1960, was $1,750.00 per share, or a total of $663,250.00 and the costs are taxed herein as follows: 68% to plaintiffs and 32% to the defendant.

Dated this 18th day of May, 1963.

By the Court:

EUGENE J. KEAN,
Judge,
Sixth Judicial District of Iowa."

In the Supreme Court of the United States

OCTOBER TERM, 1969

No. 412

FRED W. WOODWARD and ELSIE M. WOODWARD, F. R. WOODWARD and M. JEANNE WOODWARD, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT

As of 1960, petitioners collectively owned a majority interest in the Telegraph Herald, an Iowa corporation. Because the charter of the corporation was due to expire in 1961, its stockholders met on June 9, 1960, and, by majority vote adopted a resolution extending the existence of the corporation perpetually. Shortly thereafter, a certificate for the renewal of the corporate charter was issued by the Secretary of State of Iowa.

One of the shareholders, who owned 379 of the 1,200 outstanding shares, voted against renewal of the charter. Under Iowa law, those stockholders voting for renewal were obligated to purchase the dissenter's shares at "real value". On February 9, 1962, all of the majority shareholders, except one, commenced an appraisal proceeding in the Iowa courts. After proceedings in the trial court and the Supreme Court of Iowa, the real value of the dissenter's shares was determined to be $1,620 per share. Following entry of final judgment, petitioners, as majority stockholders, purchased the dissenting shares on July 16, 1965. During 1963, petitioners paid attorneys', accountants', and appraisers' fees, along with other costs of services rendered in connection with the determination of the value of the dissenter's shares.

The issue here is whether these costs are currently deductible against ordinary income under Section 212 of the 1954 Code as expenses for the production or collection of income, or whether they are nondeductible capital expenditures under Section 263.

The Tax Court held that the costs incident to the value-setting litigation were nondeductible capital expenditures which were to be added to petitioners' cost bases in the acquired stock. (Pet. App. A, pp. A-1-A-9.) On petitioners' appeal, the Eighth Circuit affirmed. (Pet. App. B, pp. A-20-A-33.)

The Seventh Circuit considered the identical question in *Hilton Hotels Corp.* v. *United States*, 410 F. 2d 194, pending on the government's petition for a writ of certiorari, No. 528, this Term. *Hilton Hotels* arises in the context of a statutory merger and in-

volved the costs of a similar appraisal proceeding to fix the value of dissenters' shares. The Seventh Circuit held that such costs were currently deductible as ordinary and necessary business expenses under Section 162. The decision here thus is in direct conflict with that of the Seventh Circuit.[1]

In view of the conflict between the courts of appeals and the administrative importance of the question (see petition for a writ of certiorari in No. 528, p. 16, n. 14), respondent does not object to the granting of this petition.

Respectfully submitted.

ERWIN N. GRISWOLD,
Solicitor General.

AUGUST 1969.

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[1] We do not agree, however, with petitioner's assertion (Pet. 10) of a conflict between the instant decision and that of the Ninth Circuit in *Heller* v. *Commissioner*, 147 F. 2d 376, certiorari denied, 325 U.S. 868. As we note in our *Hilton Hotels Corp.* petition (pp. 11-12, n. 11), in our view *Heller* was overruled, *sub silentio*, by the Ninth Circuit's later decision in *Spangler* v. *Commissioner*, 323 F. 2d 913.

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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1969

No. 412

FRED W. WOODWARD and ELSIE M. WOODWARD
F. R. WOODWARD and M. JEANNE WOODWARD
Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE
Respondent

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF FOR THE PETITIONERS

OPINIONS BELOW

The opinion of the Tax Court of the United States is reported at 49 TC 377; viz., the majority opinion by Judge Norman O. Tietjens appears at A. 28,[1] the dissenting opinion of Judge J. Gregory Bruce appears at A. 37 and the dissenting opinion of Judge William M. Fay appears at A. 46.

[1] "A." refers to the tan-covered booklet entitled "APPENDIX".

The opinion of the Court of Appeals for the Eighth Circuit is reported at 410 F. 2d 313; viz., the majority opinion by Judge M. C. Matthes appears at A. 49.

JURISDICTION

The judgment of the Court of Appeals was entered on May 2, 1969 (A. 64). The petition for a writ of certiorari was filed on July 31, 1969, and was granted on October 20, 1969 (A. 65). The jurisdiction of this Court is invoked under 28 U. S. C. 1254 (1).

QUESTION PRESENTED

Are amounts paid by majority stockholders (Taxpayers) for attorneys', appraisers' and accountants' fees for services rendered in connection with a state court litigation, the primary purpose of which was the judicial determination of the real value of a dissenting shareholder's common stock, deductible, under the provisions of Section 212 of the Internal Revenue Code of 1954, as ordinary and necessary expenses paid or incurred for the management, conservation, or maintenance of property held for the production of income?

OR

in the alternative

Are fees and costs paid by majority shareholders (Taxpayers) relative to an equitable action arising under a state appraisal statute wherein the only issue was the "real value" of the common stock owned by a dissenting shareholder—title to such stock not being at issue or in dispute—capital expenditures incurred in connection with the acquisition of the title to the stock owned by the dissenting shareholder and therefor nondeductible under the provisions of Section 263 of the Internal Revenue Code of 1954?

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Section 212 of the Internal Revenue Code of 1954 follows, to-wit:

"Section 212. Expenses for Production of Income

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—

* * * * * * *

(2) for the management, conservation, or maintenance of property held for the production of income;"

The pertinent provisions of Section 263 of the Internal Revenue Code of 1954 follows; to-wit:

"Section 263. Capital Expenditures

(a) General Rule.—No deduction shall be allowed for—

(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate."

The pertinent provisions of the Treasury Regulations applicable to the foregoing code sections, appear in the App., infra,[2] p. A-6 re Section 1.212-1 and in the App., infra, p. A-9 re Section 1.263(a)-2.

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[2] "App., infra," refers to the "APPENDIX" contained herein.

STATEMENT OF THE CASE

The petitioners, Fred W. Woodward and Elsie M. Woodward, are husband and wife (A. 2). The petitioners, F. R. Woodward and M. Jeanne Woodward, are husband and wife (A. 2). All of the petitioners (hereinafter referred to jointly as "Taxpayers") are residents of Dubuque, Iowa (A. 2). Each couple filed a joint federal income tax return for calendar year 1963 with the District Director of Internal Revenue at Des Moines, Iowa (A. 2).

The jurisdiction of the Tax Court of the United States, the court of first instance, was invoked as a result of the filing by the taxpayers, within the time permitted by Section 6213 of the Internal Revenue Code of 1954, 26 U. S. C., Section 6213, of petitions for the redetermination of their 1963 federal income tax.

The Telegraph-Herald was originally organized as a profit corporation under the laws of the State of Iowa in 1901. Its corporate existence was renewed in 1921 and in 1941 (A. 18 and 30). The corporation is engaged in publishing a daily newspaper, operating a commercial printing plant and operating a radio station in Dubuque, Iowa (A. 2 and 19).

Pursuant to the 1941 renewal of its charter the corporate existence of the Telegraph-Herald was extended for a twenty year period to November 1, 1961 (A. 18 and 30). Section 491.25 of the 1958 Code of Iowa provides a statutory procedure for the renewal of a corporation existing for a term of years (A. 31).

On May 24, 1960, at the direction of the President of the corporation, written notice was given to each of the common stock shareholders of the Telegraph-Herald of a special meeting of such shareholders to be held at the office of the corporation in Dubuque, Iowa on June 9, 1960, for the purpose of renewing the corporation's existence

perpetually and placing certain restrictions upon the sale and transfer of its outstanding common stock (A. 9).

The issued and outstanding common capital stock of the Telegraph-Herald, at all times pertinent, consisted of 1,200 shares of $100 par value common stock. The ownership of the shares of common stock of the Telegraph-Herald as shown by the books and records of the corporation on June 9, 1960, was as follows (A. 3 and 19); to-wit:

Common Stockholder	Number of Shares
Fred W. Woodward	398
F. R. Woodward	58
M. Jeanne Woodward	55
Elsie M. Woodward, F. Robert Woodward, M. Jeanne Woodward and American Trust and Savings Bank of Dubuque, Iowa, as Trustees of Fred W. Woodward Trust No. 1	200
Elsie M. Woodward, F. Robert Woodward, M. Jeanne Woodward and American Trust and Savings Bank of Dubuque, Iowa, as Trustees of Fred W. Woodward Trust No. 2	100
Charles Murphy, Executor of the Estate of Ellen Murphy, Deceased	10
Margaret M. Quigley	379
Total number of shares of the common stock of the Telegraph-Herald issued and outstanding on June 9, 1960	1,200

At the special meeting of the common stock shareholders of the corporation held on June 9, 1960, at which all 1,200 shares of the outstanding $100 par value common stock were represented, a resolution proposing perpetual existence and renewal was submitted for adoption (A. 11).

The proposed resolution was approved and adopted at said meeting by all common stock shareholders except Margaret M. Quigley, who voted all of her 379 shares of stock against the adoption of the resolution (A. 14).

Margaret M. Quigley acquired her 379 shares of stock of Telegraph-Herald by bequest from her husband, Joseph C. Quigley, who died January 22, 1952 (A. 20).

The common capital stock of the Telegraph-Herald has not been sold or offered for sale nor have any bids been made to purchase said stock during the years 1950 to June 9, 1960 (A. 20).

A certificate for the renewal of the Telegraph-Herald's corporate charter was issued by the Secretary of State for the State of Iowa, on or about June 10, 1960 (A. 4).

The Taxpayers having voted with the majority of the Stockholders for the renewal of the corporate charter of the Telegraph-Herald on June 9, 1960, were obligated and required by the terms and conditions of Section 491.25 of the 1958 Cole of Iowa to purchase the dissenting shareholder's 379 shares of the common stock of the Telegraph-Herald at its "real value" (A. 4). This duty of the majority stockholders to purchase the stock of the dissenting stockholder arose as of the date the vote for renewal was taken, June 9, 1960 (A. 21 and 23). The statute imposes no duty on the corporation, as such, to purchase the stock of the dissenting stockholder, and its purchase by the majority stockholders was neither a condition precedent to the renewal of the corporate charter nor a condition subsequent to the continued existence of the corporation (A. 4 and 26). The renewal of the corporate charter was effective upon the expiration of the existing charter (A. 4 and 26).

The dissenting stockholder, Margaret M. Quigley, and the affirmative voting stockholders were unable to agree as to the real value of her Telegraph-Herald stock (A. 17

and 24), and on the 9th day of February, 1962, the affirmative voting stockholders, with the exception of Charles Murphy, Executor of the Estate of Ellen Murphy, Deceased, filed an equitable action (A. 15) in the District Court of Iowa in and for Dubuque County asking the Court to determine and fix the real value of the dissenting shareholder's 379 shares of the common stock of the Telegraph-Herald as of June 9, 1960, pursuant to Section 491.25 of the 1958 Code of Iowa (A. 17). The trial Court, in a decision rendered on May 18, 1963, determined a real value of $1,750 per share (A. 22).

All parties appealed from the real value determination of the District Court of Iowa in and for Dubuque County, to the Supreme Court of Iowa. In a decision filed on February 9, 1965 (A. 5 and 23) the Supreme Court of Iowa determined and fixed the real value of the dissenting shareholder's common stock of the Telegraph-Herald at $1,650 per share, **Woodward v. Quigley**, 257 Iowa 1077, 133 N. W. 2d 38 (1965). The affirmative voting shareholders were granted a rehearing. The Supreme Court of Iowa, in a decision filed on June 30, 1965, modified its initial determination and held that the real value of such common stock was $1,620 per share, **Woodward v. Quigley**, 257 Iowa 1077, 136 N. W. 2nd 280 (1965) (A. 6).

The case of **Woodward v. Quigley** (A. 15) was brought to determine the extent of the liability created by the vote for renewal of the corporate charter, a matter involving a purely private right between the majority and dissenting stockholders (A. 6 and 23). The corporation was not a party thereto and the action did not involve its business operations (A. 15, 20 and 26). The majority stockholders recognized their obligation under the Iowa statute to purchase the stock of the dissenting stockholder (A. 23). Being unable to agree upon the "real value" of the stock in question, the primary, and, in fact, the only purpose of the litigation was to obtain a court determination of the

real value of the stock (A. 17, 21 and 24). Neither a money judgment nor the enforcement of a contract or statutory obligation was sought or determined (A. 17, 20 and 24). Title to the stock was never in question (A. 2, 16, 18, 20 and 24). The Iowa appraisal statute, Section 491.25, under which the equitable action was instituted presupposes that the dissenting stockholder owns the shares which the court is to evaluate (A. 4). Legal title remained in the dissenting stockholder until, on July 16, 1965, the majority stockholders paid for the shares of stock owned by the dissenting stockholder, Margaret M. Quigley (A. 6 and 43).

During the taxable year 1963 the majority stockholders voting to extend the corporate existence of the Telegraph-Herald, with the exception of Charles Murphy, Executor of the Estate of Ellen Murphy, Deceased, paid attorneys', accountants' and appraisers' fees, costs and disbursements in the total of $37,890.75 for services rendered in connection with the determination of the real value of the dissenting shareholder's stock (A. 6).

The Taxpayers, for the taxable year 1963, deducted their proportionate share of the attorneys', accountants' and appraisers' fees, costs and disbursements from their respective adjusted gross incomes, as ordinary and necessary expenses paid for the management, conservation or maintenance of property held for the production of income pursuant to Section 212 of Internal Revenue Code of 1954 (A. 7).

The Commissioner of Internal Revenue disallowed the deductions with the explanation, contained in his Notices of Deficiency, that the amounts claimed "for Professional fees incurred in relation to income producing property are not allowable because the fees represent capital expenditures incurred in connection with the acquisition of capital stock of a corporation, Telegraph-Herald, instead of deductible expenditures" (A. 34).

SUMMARY OF ARGUMENT

The granting of certiorari in this case presents a question most unique while the problem for consideration is as contemporary as "Cash McCall" and has been undoubtedly precipitated and accelerated by a dynamic and vital economy. The question, it is suggested, will ultimately be determined by an analysis of nineteenth century economic history.

Simply stated, the problem involves the characterization for income tax purposes of litigation fees and costs as nondeductible capital expenditures or as ordinary and necessary expenses currently deductible.

Technically stated, the problem involves the determination of the extent to which Section 263 (a)(1) re capital expenditures limits Section 212 (2) re expenses for production of income in areas where fees and costs are incurred in litigation involving title to "property held for the production of income", e. g., stock of a closely held corporation.

The majority stockholders (Taxpayers) paid attorneys', appraisers' and accountants' fees for services rendered in connection with a state court litigation, the primary purpose of which was the judicial determination of the "real value" of a dissenting shareholder's common stock. The equitable action arose under a state appraisal statute granting a dissenting shareholder the right to "get out of the corporation with the 'real value' of her stock" (A. 25). The object or standard inherent in the appraisal statute is "to ascertain the actual worth of that which the dissenter loses because of his unwillingness to go along with the controlling stockholders, that is, to indemnify him" (A. 24).

The Supreme Court of Iowa in its opinion determining the "real value" of the dissenting shareholder's common

stock reviewed the legislative history and development of the Iowa Appraisal Statute and concluded that the transaction precipitated by the refusal of the dissenting shareholder to continue as an investor in the corporation for the renewal period was not to be characterized as a "sale" and purchase transaction but rather as a procedure to pay the dissenting shareholder his aliquot share in the corporation (A. 24 and 25). The Court further explained that the majority shareholders were given the right to continue the corporation in return for the payment to the dissenting shareholder of her fair share of the "real value" of the corporation (A. 27). As twenty years was the life of the corporation, the dissenting shareholder had not bound herself to remain such after the expiration of that definite period of time. Accordingly, she had the right to her proportionate share of the assets of the corporation.

The taxpayers contend that the application of the primary purpose test and/or the test of origin and consequence to the factual situation involved in the state court appraisal action will result in a characterization of the litigation costs and fees as ordinary and necessary expenses re Section 212(2).[3]

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[3] It is apparent from the Senate Committee Report accompanying the Revenue Act of 1942 that Congress intended that some expenditures pertaining to assets of a purely capital nature were to be allowed as deductions from gross income. . . . "Ordinary and necessary expenses so paid or incurred are deductible under section 23(a)(2) even though they are not paid or incurred for the production or collection of income of the taxable year or for the management, conservation, or maintenance of property held for the production of such income. **The term 'income' for this purpose comprehends not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years,** and is not confined to recurring income but applies as well to gain from the disposition of property" (App., infra p. [illegible]).

A-14

ARGUMENT

I

(a). The Court of Appeals, although the only issue presented in the state court litigation out of which expenses in question arose was the real value of the stock owned by the dissenting shareholder—title to such stock not being at issue or in dispute—erred in failing to give effect to the "primary purpose test" which this Court has recognized as controlling in the determination of the character of litigation expenses; e. g.; to differentiate capital expenditures re Section 263 from ordinary and necessary expenses re Sections 162 and 212.

(b). In determining the character of litigation expenses, the controlling test is that of primary purpose; viz., even though title may be involved in the litigation, if the defense of or the perfection of or the acquisition of title is not the primary purpose of the litigation, such expenses are deductible.

The tax law pertinent to the characterization of amounts paid by majority stockholders (Taxpayers) for attorneys', appraisers' and accountants' fees for services rendered in connection with a state court litigation, the primary purpose of which was the judicial determination of the real value of a dissenting shareholder's common stock as either an ordinary and necessary expense re Section 212 (2) or as a capital expenditure re Section 263 is exhaustedly yet lucidly enunciated in this Court's decisions of Bingham v. Commissioner, 325 U. S. 365 (1945); Deputy v. du Pont, 308 U. S. 488 (1939); Kornhauser v. U. S., 276 U. S. 145 (1928); Lykes v. U. S., 343 U. S. 118 (1952); U. S. v. Gilmore, 372 U. S. 39 (1963); Welch v. Helvering, 290 U. S. 111 (1933).

The "primary purpose test", conceived in Kornhauser v. U. S., 276 U. S. 145 (1928), is elaborated and explained in the decisions of Heller v. Commissioner, 2 T. C. 371 (1943), aff'd 147 F. 2d 376 (9th Cir. 1945), cert. denied 325 U. S. 868 (1945); Helvering v. Stormfeltz, 142 F. 2d 982 (8th Cir. 1944); Hilton Hotels Corp. v. U. S., 410 F. 2d 194 (7th Cir. 1969); Industrial Aggregate Company v. U. S., 284 F. 2d 639 (8th Cir. 1960); Manufacturers Hanover Trust Company v. U. S., 312 F. 2d 785 (Ct. Cl. 1963), cert. denied 375 U. S. 880 (1963); Rassenfoss v. Commissioner, 158 F. 2d 764 (7th Cir. 1946); Ruoff v. Commissioner, 30 T. C. 204 (1958), reversed and remanded by 277 F. 2d 222 (3d Cir. 1960); Smith Hotel Enterprises, Inc. v. Nelson, 236 F. Supp. 303 (D. C. Wis. 1964). The primary purpose doctrine as developed in these decisions is used to differentiate capital expenditures of Section 263 from ordinary and necessary expenses under Sections 162 and 212.

The essential facet of the primary purpose doctrine is that it is used to delve deeply into a fact situation to characterize the particular litigation costs as either a capital expenditure or as an ordinary and necessary expense. Accordingly, it is essential that the legislative history and development of the Iowa Appraisal Statute be reviewed and examined.

The action in **State v. Shellsburg Grain & Lumber Co.**, 53 N. W. 2d 143 (Iowa 1952), was ". . . predicated upon Section 491.25, Code of 1946, I. C. A., which states: 'Corporations * * * may be renewed * * * if a majority of the votes cast * * * be in favor of such renewal, **and if those voting for such renewal will purchase at its real value the stock voted against such renewal.**'" The emphasized portion of Section 491.25, ". . . has been in substance the law of this state since the Code of 1851."

In **Woodward v. Quigley**, 133 N. W. 2d 38 (Iowa 1965), the Supreme Court of Iowa outlined the economic and

legislative history pertinent to the Iowa Appraisal Statute as follows on pages 42 and 43 of 133 N. W. 2d; to-wit:

> "The original statute was similar to those enacted in most states to modify the common law rule which required unanimous consent of all the stockholders for a substantial change in the corporate structure. The increase in the number of corporations and stockholders made such a rule impracticable. The statute was enacted to permit a majority to vote to renew the corporate life and at the same time allow a dissenting minority to get out of the corporation with the 'real value' of its stock. It prevented the minority from being squeezed out for a lesser price.
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> "The U. S. Supreme Court discussed this type of statute in Voeller v. Neilston Warehouse Co., 311 U. S. 531, 61 S. Ct. 376, 85 L. Ed. 322, and in speaking through Justice Black, said:
>
> 'At common law, unanimous shareholder consent was a prerequisite to fundamental changes in the corporation. This made it possible for an arbitrary minority to establish a nuisance value for its shares by refusal to cooperate. To meet the situation, legislatures authorized the making of changes by a majority vote. This, however, opened the door to victimization of the minority. To solve the dilemma, statutes permitting a dissenting minority to recover the appraised value of its shares, were widely adopted.'
>
> "In Iowa prior to 1933, the statute as then worded and interpreted required the majority to purchase the dissenter's stock as a condition precedent to the issuance of a certificate of corporate renewal. In those instances where the majority was unable to finance the purchase of the minority stock, the minority was in a position to force a liquidation against the will of the majority.

"In 1933, the 45th General Assembly attempted to correct this injustice by adding the following sentence:

'Stockholders voting for renewal shall have three years from the date such action for renewal was taken in which to purchase the stock voted against such renewal, which purchase price shall bear interest at eight (now five) percent per annum from the date of such renewal action until paid, * * *.'

"In State ex rel. Robbins v. Shellsburg Grain & Lumber Co., 243 Iowa 734, 739, 53 N. W. 2d 143, 145, we discuss this historical development saying:

" 'It is true * * * the object of the purchase clause in the statute is to protect a minority stockholder against roughshod tactics upon the part of a majority group.' We conclude that the 1933 amendment 'was enacted to protect the majority group in voting for a renewal of the corporate charter. It gave to them a three-year period of grace within which to arrange for payment of the real value of the dissenter's stock, without being harassed by judgments and executions.' We do not here have a question of the issuance of a certificate of renewal or harassment by judgment or executions. We are concerned with the real value of defendant's stock and the amendment did not change the basic purpose of the statute. *The majority was given the right to continue the corporation in return for the payment to the minority of its fair share of the real value of the corporation.*" (Emphasis supplied.)

In **Terrell v. Ringgold County Mut. Telephone Co.**, 282 N. W. 702 (Iowa 1938), at page 704, Justice Mitchell stated as follows in his dissenting opinion; to-wit:

"The United States Supreme Court in Apsey v. Kimball, 221 U. S. 514, 31 S. Ct. 695, 55 L. Ed. 834,

under a somewhat similar law of Congress in connection with the extension of the corporate existence of a National Bank, held that when the election is made by the majority to extend the corporate charter and by the dissenting minority stockholder to withdraw, the latter thereupon ceases to be a shareholder in the corporation."

In **Apsey v. Kimball**, 221 U. S. 514 (1911), this Court speaking through Mr. Justice Day enunciated the legal relationships of the majority shareholders and the dissenting shareholder precipitated by a vote renewing a corporation's existence pursuant to a national banking statute, as follows; to-wit:

"The suits were originally brought by . . . receiver of the First National Bank of Chelsea, Massachusetts, against George E. Kimball . . . under § 5151 of the Revised Statutes of the United States (U. S. Comp. Stat. 1901, p. 3465), making the shareholders of a national banking association individually responsible in a sum equal to the amount of their stock therein at the par value thereof, in addition to the amount invested in such shares.

"In each of the cases the courts whose judgments are here for review reached the conclusion that the shareholder sued was not liable to the receiver on account of such stautory obligation.

* * * * * * * *

"As originally organized, national banks had a corporate existence of twenty years. By the act of July 12, 1882, 22 Stat. at L. chap. 290, p. 162, U. S. Comp. Stat. 1901, p. 3457, such banks were authorized to continue their corporate existence for another twenty years. As pointed out in § 2 of the act, *such extension must be authorized by consent in writing of share-*

holders owning not less than two thirds of the capital stock of the association. Before granting a certificate of approval of such extension, the Comptroller of the Currency is required to cause a special examination of the bank to be made, and if, after such examination, or otherwise, it appears to him that the association is in a satisfactory condition, he is required to grant his certificate of approval, or, if it appear that the condition of the association is not satisfactory, he shall withhold the same.

"Section 5, which is the important one in this case, provides:

'That when any national banking association has amended its articles of association, as provided in this act, and the Comptroller has granted his certificate of approval, any shareholder not assenting to such amendment may give notice in writing to the directors within thirty days from the date of the certificate of approval, *if his desire to withdraw from said association, in which case he shall be entitled to receive from said banking association the value of the shares so held by him,* to be ascertained by an appraisal made by a committee of three persons, one to be selected by such shareholder, one by the directors, and the third by the first two; and in case the value so fixed shall not be satisfactory to any such shareholder, he may appeal to the Comptroller of the Currency, who shall cause a reappraisal to be made, which shall be final and binding; and if said reappraisal shall exceed the value fixed by said committee, the bank shall pay the expenses of said reappraisal, and otherwise the appellant shall pay said expenses; *and the value so ascertained and determined shall be deemed to be a debt due, and be forthwith paid, to said shareholder from said bank; and the shares so surrendered and appraised shall, after due notice, be*

sold at public sale, within thirty days after the final appraisal provided in this section."

* * * * * * * *

"The question then, is: did the shareholders, defendants in error, cease to be such, or were they still shareholders when the bank failed, and liable to assessment for the benefit of creditors? It is the contention of the plaintiff in error that they did not cease to be shareholders until, under § 5 of the act, an appraisal of the value of the stock had been made and the certificates of stock duly surrendered. Upon the other hand, the defendants in error contend that, upon complying with the steps required of them, in giving notice, appointing an appraiser, and using diligence to have an appraisal, *they ceased to be shareholders, and were no longer liable to pay the assessment made.*

"The First National Bank of Chelsea was originally incorporated, under the statute, for a period of twenty years, and while that was its span of corporate life, the defendants in error became shareholders therein, received certificates of shares, and were duly registered as shareholders. *As twenty years was the life of the corporation, the shareholders had not bound themselves to remain such after the expiration of that definite period of time. As the statute originally stood, the venture would necessarily terminate at the end of that time.*

"Congress recognized that it might be proper to continue the organization, that at least a part of the shareholders might desire to do so, and therefore the act of July 12, 1882, provided for the extension of the corporate existence of the bank. It was also recognized that a part of the shareholders might wish to retire from the venture, and it was therefore provided that two thirds of the shareholders must acquiesce to continue the bank's existence, ...

* * * * * * * *

"We agree with the courts below that the defendants ceased to be shareholders after thus complying with the statute. Section 5151 of the statute makes shareholders liable to the assessment. The statute makes specific provision for the manner in which the shareholder may sever his connection with the corporation. These necessary steps were taken, as the agreed facts show. *The shareholders had a right to end their connection with the association at the termination of the period of original incorporation, or, if they so desired, they might go on with the association in its renewed life.*

"Section 5 provides for the manner of manifesting such determination to terminate their relations with the corporation at the expiration of its original life. . . . We cannot agree with the contention of the plaintiff in error, that they ceased to be shareholders only when the appraisal had been made, and the certificate of shares surrendered."

* * * * * * * *

"These shareholders had done all that the law required of them. *Any further action to evidence the changed relation of the shareholders to the bank, upon its books, was not a matter within the control of the shareholders.*

"It is argued that the construction we have given the statute may amount to a reduction of the capital stock, to the detriment of creditors. *The corporation in which these shares were held expired in twenty years. The creditors after that time had no right to hold these shareholders in face of the law, of which all must take notice, permitting the retirement of non-assenting shareholders.* If this results in the diminution of outstanding shares of the bank assessable for creditors, it was the very thing made possible by the amended statute. New shareholders are to be brought

in by the sale of the stock, as provided in § 5. *It is true that these defendants retained their certificates, but they were not obliged to surrender them except upon payment for their shares.*

"It is said, had the corporation made a large gain, instead of failing after the action of these shareholders, in giving notice and naming their appraiser, they might have withdrawn their notice, and obtained the benefit of such increase, but this depends upon the construction of the statute. *As we view it, when the shareholders made their election to retire at the end of the first twenty-year period of corporate organization, and took the steps required* in § 5, by giving notice and appointing an appraiser to obtain a valuation of and payment for their shares of stock, *they thereby ceased to be shareholders beyond the original twenty-year term of the life of the corporation, and they could neither share its profits, nor be compelled to bear its burdens.*" (Emphasis supplied.)

Notwithstanding Judge Matthes of the Court of Appeals (A. 55) and Judge B[illegible]e of the Tax Court (A. 43, Footnote 7) to the contr[illegible] is strenuously urged that an analytical study and review of the Iowa cases cited herein, together with the two opinions of this Court (Viz., Voeller v. Neilston Warehouse Co., 311 U. S. 531 (1941), and Apsey v. Kimball, 221 U. S. 514 (1911), substantiates the Taxpayers' interpretation of the Iowa corporate law (infra, pp. 20-21) relative to the legal rights and allegations of the majority shareholders and the dissenting shareholder arising on June 9, 1960, pursuant to the term and condition of the Iowa Appraisal Statutes.

Admittedly, there is not an overabundance of decisions of the Supreme Court of Iowa interpreting the renewal and appraisal statute. However, it would seem that if the case of Woodward v. Quigley, 133 N. W. 2d 38 (Iowa

1965), is first analyzed in the context in which it was written by Justice Stuart, e. g., as determinative of issues arising in the field of corporate law, the conclusion is inescapable that the policy of Iowa law is in accord with the aforesaid decisions of this Court. For instance, at A. 24 and A. 25, Justice Stuart refuses to discount the value of the dissenting shareholder's common stock for a broker's commission and because it represents a minority interest, for the reason that this is not a **sale of stock** but a judicial determination of real value to idemnify the withdrawing shareholder for that which he loses because of his unwillingness to go along with the controlling stockholders. Justice Stuart is in effect pointing to the crux of this transaction that the purpose of the statute is to provide a procedure that will allow a dissenting shareholder to get out of the corporation with the real value of his stock.

The Supreme Court of Iowa in the case of **Woodward v. Quigley**, 133 N. W. 2d 38 (Iowa 1965), at page 43, cited **Voeller v. Neilston Warehouse Co.**, 311 U. S. 531 (1941), with approval. In the latter case, this Court speaking through Mr. Justice Black stated as follows at pages 535 and 536 of 311 U. S.; to-wit:

> "The objective of the Ohio statute permitting the right of appraisal to dissenting shareholders was the elimination of abuses that had long been a fixture in the field of corporate finance. . . . The corporation was given the right to avoid the effect of being compelled to pay the claimed value either by making a counter-offer or by requesting an appraisal. **In addition, it was given the right to avoid both appraisal and payment of the claimed value by abandoning its original purpose to sell its assets.** The dissenting shareholders could, by requesting an appraisal, likewise avoid accepting the corporation's counter-offer.

Thus the corporation is compelled to pay or the dissenting shareholder to accept payment of the amount of the offer or counter-offer only if none of the many available alternatives are pursued before the expiration of a six-month period.

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"It is true, as respondent urges, that after the majority authorizes the corporation to effect a sale, the alternatives are thereafter expressly open only to the corporation and the dissenters; no provision is made for notice to the majority shareholders as individuals. **But the majority, by their vote approving the sale of assets, have indicated their intention to remain part and parcel of the corporation; the dissenters, on the other hand, by voting against the sale and by demanding payment, have indicated an intention to sever relationships.**" (Emphasis supplied.)

In the normal stock acquisition transaction there exists a willing buyer and a willing seller, neither of which are under any compulsion to buy or sell. In the case now before this Court, such is not the situation. The seller (the dissenting shareholder) was willing enough—she chose to sell her stock by her action in voting against the renewal of the corporate charter of the Telegraph-Herald. But there was no willing buyer—the taxpayers were required by statute to buy the shares of the dissenting shareholders. Thus, an essential ingredient of the normal stock acquisition transaction is missing . . . the willing buyer with a desire to purchase.

In essence, it was the unilateral act of the seller (the dissenting shareholder) that precipitated the sale transaction. The statute, in effect, creates a market for the dissenting shareholder if she wishes to sell her stock, viz., by requiring the majority stockholders to purchase it. The majority shareholders have absolutely no control

over the situation . . . all of the discretions, options and privileges of the statute are conferred upon the dissenting shareholder. If the dissenting shareholder exercises her option to sell her stock . . . by voting against the renewal of the corporation's charter . . . the majority shareholders are compelled to purchase such stock.

Thus, it becomes apparent, **that an involuntary obligation to purchase the stock of the dissenting shareholder has been imposed by statute upon the Taxpayers** (majority shareholders).

A cursory examination and analysis of **Terrell v. Ringgold County Mut. Telephone Co.**, 282 N. W. 702 (Iowa 1938); **State v. Shellsburg Grain & Lumber Co.**, 53 N. W. 2d 143 (Iowa 1952); **Robbins v. Beatty**, 67 N. W. 2d 12 (Iowa 1954); **Woodward v. Quigley**, 133 N. W. 2d 38 (Iowa 1965); **Melsha v. Tribune Publishing Co.**, 51 N. W. 2d 425 (Iowa 1952); **Apsey v. Kimball**, 221 U. S. 514 (1911); and, **Voeller v. Neilston Warehouse Co.**, 311 U. S. 531 (1941) reveals the following relative to the legal relationships of the majority shareholders and the dissenting shareholders subsequent to a vote renewing a corporation's existence pursuant to Section 491.25 of the 1958 Code of Iowa; to-wit:

(1). Every stockholder of an Iowa corporation for pecuniary profit, as an essential element of his contract, has the right to withdraw or retire the capital which he has invested at the termination of the corporation's life or period.

(2). If the majority of the stockholders favor a renewal of the life of the corporation, any stockholder has the election to oppose such renewal.

(3). In the event that the majority of the stockholders vote in favor of renewing the corporate charter, such majority stockholders **MUST PURCHASE** the stock of the dissenting shareholders at

its real value; and conversely, such dissenting shareholders **MUST SELL** their stock to the majority stockholders at its real value. The duty of the majority stockholders (Taxpayers) to purchase the stock of the dissenting stockholder arose as of the date the vote for renewal was taken; e. g., June 9, 1960.

(4). **The statute imposes no duty on the corporation, as such, to purchase the stock of the dissenting stockholder, and its purchase by the majority stockholders is neither a condition precedent to the renewal of the corporate charter nor a condition subsequent to the continued existence of the corporation.**

(5). If the renewal instrument is timely filed with the Secretary of the State of Iowa, the renewal of the corporation's charter will take effect immediately upon the expiration of the corporation's previous period of existence, and in such case, the corporate existence is considered as having been extended without interruption. A certificate for the renewal of the Telegraph-Herald's corporate charter was issued by the Secretary of State for the State of Iowa, on or about June 10, 1960 (A. 4).

(6). When the election is made by the majority stockholders to extend the corporate charter and by **THE DISSENTING MINORITY STOCKHOLDER** to withdraw, the latter thereupon **CEASES TO BE A STOCKHOLDER OF THE CORPORATION**; e. g., the dissenting shareholder is no longer entitled to vote such stock, is no longer entitled to receive any dividends declared on such stock, etc.

(7). The corporation renewing its charter continues to own all of its assets and property free and clear of any lien or liability to the dissenting stockholder.

(8). The dissenting stockholder cannot require that the purchase of his stock by the majority stockhold-

ers be consummated until three years after the date of such action for renewal was taken.

(9). **The dissenting stockholder cannot bring as equitable action for the determination of the real value of his stock until three years after the date of such action for renewal was taken.**

(10). The dissenting stockholder can not have his claim for the real value of his stock adjudicated a lien against the corporation's property.

(11). The dissenting stockholder can not have a receiver appointed to take charge of all of the property, assets and books of the corporation in order to protect his claim.

(12). The Supreme Court of Iowa in **Woodward v. Quigley** (A. 23-27), discussed the object and purpose of the appraisal statute stating as follows, to-wit:

> "Our 'real object is to ascertain the actual worth of that which the dissenter loses **because of his unwillingness to go along with the controlling stockholders**, that is, to indemnify him.' "
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> • • • • • • • •
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> ". . . **the dissenting stockholder was entitled to receive 'the aliquot proportion** which the number of shares held would be entitled to receive in the distribution of the net amount of the corporate funds in which his particular kind of stock would be entitled to share.' "
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> • • • • • • • •
>
> ". . . **the stockholder is entitled to be paid for that which has been taken from him, viz., his proportionate interest in a going concern.**"
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> • • • • • • • •
>
> ". . . The majority was given the right to continue the corporation in return for the payment

to the minority of its fair share of the real value of the corporation."

(13). The majority stockholders, in addition to paying the dissenting stockholder the real value of his stock, must pay "interest at the rate of five percent per annum from the date of such renewal action until paid".

An application of Section 491.25 of the 1958 Code of Iowa[4] and the foregoing propositions of law to the factual situation now before this Court reveals the following; to-wit:

(1). That the Taxpayers as majority stockholders of the Telegraph-Herald, whose corporate charter was due to expire on November 1, 1961 (A. 3, 18), had no alternative but to comply "with the provisions of this section," if the Telegraph-Herald was to continue in business as a corporate entity;

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[4] Section 491.25 of the 1958 Code of Iowa provides a statutory procedure for the determination of the rights of the affirmative voting common stock shareholders and the dissenting common stock shareholders in the case of a corporation existing for a period of years, when the majority of such common stock shareholders vote to renew its corporate charter. The pertinent portion of the statute is as follows; to-wit:

"491.25 Renewal—Conditions. Corporations existing for a period of years may be renewed . . . to exist perpetually upon compliance with the provisions of this section . . . The right of renewal is vested in the stockholders and shall be exercised by a resolution thereof adopted at any regular meeting or at any special meeting called for that purpose. Such resolution must be adopted by a majority of all the votes cast at such meeting, or by such other vote as is authorized or required in the company's existing articles of incorporation."

* * * * * * *

"In all cases of renewal, those stockholders voting for such renewal must purchase at its real value the stock voted against such renewal, and shall have three years from the date such action for renewal was taken in which to purchase and pay for the stock voting against such renewal . . ."

(2). That the extension of the life of the corporation was essential to the management of the Taxpayers' investment in the common stock of the Telegraph-Herald;

(3). That "the right of renewal is vested in the stockholders and shall be exercised by a resolution thereof adopted . . . at any special meeting called for that purpose . . ." (A. 11);

(4). That "such resolution must be adopted by a majority of all the votes cast at such meeting . . ." (A. 14);

(5). That if the resolution authorizing a renewal of the corporation's existence is adopted "THOSE STOCKHOLDERS VOTING FOR SUCH RENEWAL MUST PURCHASE . . . THE STOCK VOTED AGAINST SUCH RENEWAL. . . ."

The conclusion is inescapable that the renewal statute, Section 491.25, contains and imposes, "in all cases of renewal," an absolute obligation upon "those stockholders voting for such renewal" to purchase the stock of the dissenting shareholders at its real value. The net effect of the statutory requirement that the majority shareholders "MUST PURCHASE" the dissenting shareholder's stock is **the imposition on such majority shareholders of an involuntary obligation to purchase such stock.**

The trial court in the case of **Woodward v. Quigley** characterized the nature of the majority shareholder's statutorily imposed involuntary obligation to purchase such stock as follows (A. 21); to-wit:

"3. That plaintiffs (together with owner of 10 shares of Murphy stock) voted for the renewal of the corporate charter of Telegraph-Herald on June 9, 1960, and have the obligation to purchase defendant's 379 shares of stock of Telegraph-Herald at its 'real value' under Section 491.25, Code of Iowa,

plus interest thereon at the rate of 5% per annum from June 9, 1960, until paid."

The Iowa Supreme Court in **Woodward v. Quigley,** 133 N. W. 2d 38 (Iowa 1965), characterized the nature of the majority shareholders' statutorily imposed involuntary obligation to purchase such stock as follows (A. 24); to-wit:

"Plaintiffs recognize their obligation to purchase the stock under this statute, but the parties have been unable to agree on the 'real value' of defendant's stock. This action was brought by the majority stockholders to secure a court determination of its 'real value'."

The Court in **Smith Hotel Enterprises, Inc. v. Nelson,** 236 F. Supp. 303 (D. C. Wisc. 1964), recognized the significance of the involuntary obligation of the corporation to purchase the stock of a shareholder dissenting to a sale of substantially all of the corporation's assets under a Wisconsin appraisal statute stating as follows on page 305 of 236 F. Supp.; to-wit:

"Counsel for the plaintiff urges that the decision in Boulder is unsound in that it disregards the fact that **the taxpayer's obligation to purchase the dissenters' stock was an involuntary obligation.** Under the Oklahoma statute, as well as under the Wisconsin statute, **once the dissenters have demanded that the corporation purchase their shares at fair value, the corporation has no choice in the matter. After the demand has been made, the corporation's main concern is with keeping its liability to a minimum.** Plaintiff's argument is sound. Viewed in this light it appears that the primary purpose of the state litigation in the instant case was as a determination of the fair value of the shares, and the involvement of title was incidental. The deduction made by the taxpayer was

proper as an ordinary and necessary business expense."

In the case of **Industrial Aggregate Company v. United States,** 284 F. 2d 639 (8th Cir. 1960), the Court premised its decision that the litigation expenses in question incurred by the Taxpayers in the state court action were NOT for the defense or perfection of title, upon the "primary purpose test"—recognized as controlling in the determination of the character of litigation expenses—stating as follows on page 645 of 284 F. 2d; to-wit:

> "At the same time, ever since **Kornhauser v. United States,** 276 U. S. 145, 48 S. Ct. 219, 72 L. Ed. 505, cases recognize that the mere fact that title to property happens to be involved in litigation does not necessarily mean that expenditures of that litigation are automatically rendered nondeductible by the regulation. An example is **Levitt & Sons v. Nunan,** 2 Cir., 142 F. 2d 795, 797. Practicality and substance are to be recognized. The test which appears to have been established is that of primary purpose. Thus, if the primary or sole purpose of the suit is to perfect or defend title, the expenditures are not deductible. **Shipp v. Commissioner,** 9 Cir., 217 F. 2d 401, 402; **Lewis v. Commissioner,** 2 Cir., 253 F. 2d 821, 827-828; **Garrett v. Crenshaw,** 4 Cir., 196 F. 2d 185, 187; **Addison v. Commissioner,** 8 Cir., supra, at page 523 of 177 F. 2d. On the other hand, even though title may be involved, if its defense or perfection is not the primary purpose of the litigation, the expenditures do not encounter the barrier of the regulation's standard and they may qualify instead as ordinary and necessary expenses. **Rassenfoss v. Commissioner,** 7 Cir., 158 F. 2d 764, 767-768; **Sergievsky v. McNamara,** D. C. S. D., N. Y., 135 F. Supp. 233, 237-238; **Straub v. Granger,** D. C. W. D., Pa., 143 F. Supp. 250, 254-255."

In applying the "test of purpose" the Court stated as follows on page 647 of 284 F. 2d; to-wit:

"Thus the pleadings themselves, the agreed facts and the stipulation for settlement all compel the conclusion that the primary purpose of Oakland's institution of the state court litigation, of the taxpayer's defense of it, and of both parties in effecting the settlement, was one and the same, namely, the resolution of the issue of the taxpayer-lessee's alleged violations of the operating covenants of the four leases. That the determination of this issue involved the taxpayer's consequent right, or lack of right, to the extension, and thus involved continuing title to the leaseholds as extended, does not make this purpose any less primary."

(Footnotes Omitted.)

An application of the "primary purpose" test in the manner prescribed in **Industrial Aggregate Company v. U. S.**, 284 F. 2d 639, 646 (8th Cir., 1960) to the exhibits and stipulation of facts contained in the case now before this Court reveals the following; to-wit:

(1). An examination of the prayer for relief contained in **Exhibit 2**, the Petition in Equity filed in the District Court of Iowa pursuant to the Iowa appraisal statute, discloses that the primary and only **purpose** of the litigation was to fix and determine the real value of the stock owned by the dissenting shareholder (A. 17); to-wit:

"Wherefore, **Plaintiffs ask that the Court determine and fix the real value** of the Defendant's Telegraph-Herald capital stock as of June 9, 1960, for costs and for such other and further relief as shall be just and equitable."

The governing **purpose** in the case of **Sergievsky v. McNamara**, 135 F. Supp. 233 (D. C. N. Y. 1955) was found in the nature of the relief sought. In the case at

bar, as shown in the prayer, the relief sought by the taxpayers in the State Court litigation was the determination of the real value of the dissenting shareholder's stock.

(2). An examination of **Exhibit 3**, the decision of the District Court of Iowa, discloses that the primary and only **purpose** of the litigation was to fix and determine the real value of the stock owned by the dissenting shareholder (A. 21); to-wit:

"2. **This is an equitable proceeding to fix and determine the real value** of defendant's 379 shares of stock in the Telegraph-Herald corporation as of June 9, 1960, under Section 491.25 Code of Iowa, said stock having been voted against renewal of the corporate charter on said date."

The governing **purpose** in the case of **Rassenfoss v. Commissioner**, 158 F. 2d 764 (7th Cir. 1946) was found in the reason why the plaintiff was suing the taxpayer. In the case at bar, as shown in District Court's Opinion, the majority shareholders' reason or **purpose** for bringing the equitable action against the dissenting shareholder was to determine the real value of her Telegraph-Herald common stock.

(3). An examination of the case of **Woodward v. Quigley**, 133 N. W. 2d 38 (Iowa 1965), discloses that the primary and only **purpose** of the litigation was to fix and determine the real value of the stock owned by the dissenting shareholder (A. 24); to-wit:

"**This action was brought by the majority stockholders to secure a court determination of its 'real value.'**"

The governing purpose in the case of **Kornhauser v. U. S.**, 276 U. S. 145 (1928), focused upon the issue in the prior litigation. In the case at bar, as shown in the Iowa Supreme Court's opinion, the issue involved in the state

court litigation was the real value of common stock owned by the dissenting shareholder.

(4). An examination of the Stipulation of Facts (A. 1) discloses that the primary and only **purpose** of the litigation was to fix and determine the real value of the stock owned by the dissenting shareholder; to-wit:

> "11. . . . **The majority stockholders, . . . filed a Petition in Equity in the District Court of Iowa, in and for Dubuque County asking the Court to determine and fix the real value** of Margaret M. Quigley's stock" (A. 5).
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> • • • • • • • •
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> "14. **During the taxable year 1963 the majority stockholders . . . paid attorneys', accountants' and appraisers' fees, costs and disbursements** in the total amount of $37,890.75 **for services rendered in connection with the determination of the real value** of Margaret M. Quigley's stock . . ." (A. 6).
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> • • • • • • • •
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> "19. **Respondent concedes that the fees, costs and disbursements, paid by Petitioners . . . were reasonable in amount . . . and . . . were incurred in connection with the determination of the real value** of Margaret M. Quigley's shares of stock in the Telegraph-Herald" (A. 7).

The governing purpose in **Str[illegible] v. Granger,** 143 F. Supp. 250 (D. C. Pa. 1956), was a[illegible]ertained by emphasizing the **purpose** for which the taxpayer consulted and retained counsel. In the case at bar, as shown in the Stipulation of Fact 14 (A. 6) the **purpose** for which the Taxpayers consulted and retained counsel was ". . . in connection with the determination of the real value of Margaret M. Quigley's stock . . ."

Accordingly, it is respectfully submitted that an analysis of the pleadings, the stipulation of facts, the opinion

of the District Court of Iowa and the opinion of the Supreme Court of Iowa compel the following conclusions; to-wit:

(1). That the litigation expenses in question were paid by the Taxpayers during calendar year 1963 (A. 6).

(2). That the litigation expenses were reasonable in amount and were incurred in connection with the determination of the real value of Margaret M. Quigley's, the dissenting shareholder's, shares of stock in the Telegraph-Herald (A. 7).

(3). That the primary purpose of the majority shareholders' (Taxpayers') institution of the state court litigation was the determination of the "real value" of the stock owned by the dissenting shareholder (A. 24).

(4). That the litigation expenses **WERE NOT INCURRED** by the majority shareholders (Taxpayers) in the defense of or in the perfection of or in the acquisition of title to the stock owned by the dissenting shareholder.

(5). That the litigation expenses incurred and paid by Taxpayers in connection with the state court action are deductible under the provisions of Section 212 of the Internal Revenue Code of 1954, as ordinary and necessary expenses[5] paid for the management, conservation or maintenance of property held for the production of income.

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[5] For an illuminating and pertinent discussion of some of the guideposts erected by the courts in their determination of whether particular transactions constitute ordinary and necessary expenses, refer to the opinion of Judge Benjamin Cardozo in **Welch v. Helvering**, 290 U. S. 111 (1933), at page 114. In **Deputy v. du Pont**, 308 U. S. 488, 60 S. C. 363, 84 LE 416 (1939), the Supreme Court stated ". . . an expense may be ordinary though it happens but once in the taxpayer's lifetime".

II

(a). **The Court of Appeals erred in holding that amounts paid by majority shareholders (Taxpayers) for attorneys', appraisers', and accountants' fees and expenses were capital expenditures incurred in connection with the acquisition of the title to stock owned by a dissenting shareholder; even though the primary purpose of the state court litigation out of which the expenses arose was the determination of the "real value" of the stock owned by the dissenting shareholder.**

(b). **The Title to the stock of the Telegraph-Herald owned by the dissenting shareholder, Margaret M. Quigley, was not at issue and/or in dispute in the equitable action entitled** F. W. WOODWARD, ET AL. v. MARGARET M. QUIGLEY **brought in the District Court of Iowa In and For Dubuque County or in the subsequent appeal and rehearing before the Supreme Court of Iowa.**

The Court of Appeals, disallowed the majority shareholders' (Taxpayers) deductions for amounts paid during 1963 for attorneys', accountants' and appraisers' fees for services rendered in connection with the judicial determination of the real value of the dissenting shareholders' 379 shares of the common stock of the Telegraph-Herald cn the premise and assumption that such expenses were incurred in the acquisition of the title to the dissenting shareholders' stock. In other words, the Court of Appeals' holding of nondeductibility was based upon its contention that the title to the stock owned by the dissenting shareholder was acquired as a result of (or by reason of) litigation which precipitated the expenditures. The Court of Appeals stated as follows (A. 49); to-wit:

"The general rule is that expenses incurred in acquiring or disposing of property are capital expenditures . . . The expenditures here fall within that category. They "re-

lated directly" to the acquisition of capital assets . . . The property would never have been acquired had not the value been established and paid" (A. 58).

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"The transaction involved here was the purchase of capital assets. The valuation of these assets was vital to the purchase, and the litigation necessary for valuation was thus an integral part of the overall transaction" (A. 60).

• • • • • • • •

"What we have here, however, is litigation directly connected with the purchase of property. The expenses were incurred to establish the value of the capital assets acquired . . . They were part of the cost of acquisition" (A. 56).

The sense of the last sentence is not readily apparent unless it is interpreted to mean—"Cost of acquisition . . . **of the title** . . . to property are not deductible". The statutory and regulatory authorities cited by the Court of Appeals in support of its decision are Section 263 of the Internal Revenue Code of 1954 (App., infra p. A-4) and Sections 1.263 (a)-2 (c) and (e) of the Regulations promulgated thereunder (App., infra pp. A-9 and A-10) as well as Section 1.212-1 (k) and (n) of the Regulations (App., infra pp. A-8 and A-9). An examination thereof reveals that the frame of reference involved is—**TITLE**—. It is "defending title to property", or, "perfecting title to property", or, acquiring title to property that constitutes . . . "the barrier of the regulations standard".[6]

Stripping the rationale of the Court of Appeal's decision to its bare essentials and paraphrasing such essentials in the context of the Regulation's standard of title reveals the premises upon which the decision rests; to-wit:

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[6] **Industrial Aggregate Company v. U. S.**, 284 F. 2d 639, 645.

(1). **Acquisition of the title to the stock depended upon a determination of its real value.**

(2). **Title to the stock was perfected as a result of the Taxpayer's expenditures.**

The Court of Appeal's first premise . . . **Acquisition of the title to the stock depended upon a determination of its real value** . . . is unfounded in fact and unsupported by reasoned analysis. A consideration of the following, it is submitted, points up the fallacy of this premise; to-wit:

(1). That a contract of sale arose by operation of law as a result of the action taken on June 9, 1960 at the special meeting of the stockholders;[7]

(2). That pursuant to the terms and conditions of Section 491.25 of the 1958 Code of Iowa the statutorily imposed contract of sale became effective and binding on the majority shareholders and the dissenting shareholder on June 9, 1960;

(3). That whatever interest, property right, ownership, title, etc., the majority shareholders acquired in and to the dissenting shareholder's stock was acquired on June 9, 1960,[8] **approximately twenty months**

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[7] The cases of **Woodward v. Quigley**, 136 N. W. 2d 38 (Iowa 1965); **Terrell v. Ringgold County Mut. Telephone Co.**, 282 N. W. 702 (Iowa 1938); **State v. Shellsburg Grain and Lumber Co.**, 53 N. W. 2d 143 (Iowa 1952); **Robbins v. Beatty**, 67 N. W. 2d 12 (Iowa 1954); **Melsha v. Tribune Publishing Co.**, 51 N. W. 2d 425 (Iowa 1952); **Apsey v. Kimball**, 221 U. S. 514 (1911); and, **Voeller v. Neilston Warehouse Co.**, 311 U. S. 531 (1941); establish the legal relationships of the majority shareholders and the dissenting shareholder precipitated by a vote renewing a corporation's existence pursuant to Section 491.25 of the 1958 Code of Iowa.

[8] Subject, of course, as in all contracts of sale, to the payment of the purchase price. Analytically, upon the adoption of the resolution authorizing the renewal of the corporation's existence the majority shareholders acquired equitable title in and to the stock and the dissenting shareholder retained legal title as security.

PRIOR to their consultation with any attorney, appraiser, accountant, etc.

In essence, the statute creates a mandatory contract of sale containing the following terms; to-wit:

(a). **Seller**: dissenting stockholders—**(Margaret M. Quigley)**

(b). **Buyer**: majority stockholders—**(Taxpayers)**

(c). **Commodity Sold**: shares owned by dissenting stockholder in corporation—**(379 shares)**

(d). **Date of Contract**: date such action of renewal was taken—**(June 9, 1960)**

(e). **Purchase Price**: the real value of the shares of stock

(f). **Terms**: the purchase price shall bear interest at the rate of five per cent per annum from the date of such renewal action until paid.

(g). **Date of Payment**: ". . . shall have three years from the date such action for renewal was taken in which to purchase and pay for the stock . . ."

The crux of this transaction's chronology, so far as the acquisition or vesting of title is concerned, was **June 9, 1960.** On that day, by force and effect of the statute,[9] equitable title to the stock passed from the dissenting shareholder to the majority shareholders. The dissenting shareholder, of course, retained "bare" legal title for purposes of security; viz., payment of the purchase price. In other words, on **June 9, 1960,** the "die was cast", e. g. the dissenting shareholder had to sell and the majority

[9] Pursuant to the terms and conditions of Section 491.25 of the 1958 Code of Iowa, if the resolution authorizing a renewal of the corporation's existence is adopted ". . . those stockholders voting for such renewal must purchase . . . the stock voted against such renewal . . ."

shareholders had to buy, pursuant to the terms of a statutorily imposed contract of sale. By operation of the statute . . . on **June 9, 1960** . . . the incidences of ownership in and to the dissenting shareholder's stock were conclusively established.

It is, "Hornbook" law that whatever interest, property right, ownership, title, etc., that the majority shareholders acquired in and to the dissenting shareholder's stock was acquired on **June 9, 1960.** Accordingly, the Court of Appeal's premise that . . . **Acquisition of the title to the stock depended upon a determination of its real value** . . . is demonstrably inaccurate and in error. The conclusion is obvious, of course, that **since the majority shareholders acquired title to the dissenting shareholder's stock on June 9, 1960 . . . it would be patently impossible for the determination of the stock's real value on June 30, 1965 to be a factor in an event,** the acquisition of title by the majority shareholders, **that happened over five years prior.**[10]

The Court of Appeal's second premise . . . **Title to the stock was perfected as a result of the taxpayer's expenditures** . . . is likewise unfounded in fact and unsupported by reasoned analysis. A consideration of the following, it is submitted, points up the fallacy of this premise; to-wit:

(1). that the dissenting stockholder, Margaret M. Quigley, had "**PERFECT**" title in and to 379 shares of the common stock of the Telegraph-Herald on **June 9, 1960**[11] (A. 3, 16, 19, 21, and 23);

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[10] The real value of the dissenting shareholder's stock was finally determined by the Iowa Supreme Court on June 30, 1965; **Woodward v. Quigley,** 136 N. W. 2d 280.

[11] See infra, pp. 39 and 40 for a discussion of the "quality" and deprivation of the dissenting shareholder's title in and to the stock.

(2). that on June 9, 1960, the majority stockholders acquired, by force and effect of Section 491.25 such title to the stock as the dissenting stockholder possessed;

(3). that once the dissenting shareholder voted against renewing the corporation's existence, the primary concern of the majority stockholders was keeping their liability to a minimum;

(4). **that subsequent to June 9, 1960, the majority stockholders retained attorneys, appraisers and accountants for the sole purpose of keeping their liability to the dissenting stockholder to a minimum**; and

(5). that the amounts paid by the majority stockholders for attorneys', accountants' and appraisers' fees, costs and disbursements IN NO WAY INCREASED, ADDED TO OR BETTERED THE VALUE OF THE STOCK, e. g., perfected the title to the stock.

This Court's attention is directed to the dissent of Judge Forrester in the U. S. Tax Court case of **Ruoff v. C. I. R.**, 30 T. C. 204 (1958), reversed and remanded by 277 F. 2d 222 (3 Cir. 1960), wherein he points out the "legal quicksand" upon which the Tax Court's "theory" in the case at bar is premised. The "primary issue" of the litigation, as determined by the Third Circuit on appeal, was not ownership, but rather possession of property. Judge Forrester states that a study of the decisions pertinent to the issue of deductibility of legal fees and litigation expenses reveals the following principles of law at pages 226-227 of 30 T. C.; to-wit:

(1). ". . . that without substantial exception, the decisions which have used the touchstone of 'defense of title' to require capitalization treatment involve

factual situations where the title, at the time of taxpayer's original acquisition, was, or was alleged to be clouded. . . ."

(2). ". . . Sections 23(a)(2) and 24(a)(2) and the regulations thereunder, none of which, . . . requires or intends further capitalization treatment after taxpayer has once acquired a **perfect** title which is **unquestioned.**"

(3). The type of ". . . cost of DEFE[illegible] or PERFECTING title to property . . ." which . . . constitutes a part of the cost of the property and is not a deductible expense . . . is limited to those cases where the claimed expense sought to be deducted as such has in fact **increased, added to** or **bettered,** the value of the property upon which it was expended. . . ."

(4). the word "perfecting" as used in the phrase "perfecting title" in the regulations ". . . obviously means making perfect, thereby adding to and enhancing the value of the previously imperfect title to property . . ."

The Court of Claims in **Manufacturers Hanover Trust Co. v. U. S.**, 312 F. 2d 785 (1963), adopted this theory stating that "Under the view of Judge Forrester, dissenting in **Ruoff v. Commissioner**, 30 T. C. 204, 226-227 (1958), the proscription of the deduction of litigation expenses involved in perfecting or defending title applies only to situations where, at the time of the taxpayer's original acquisition, the title was, or was alleged to be, clouded." (at footnote 5 on page 790 of 312 F. 2d.)

The dissenting shareholder, Margaret M. Quigley, acquired the title to the 379 shares of the common stock of the Telegraph-Herald by bequest from her husband, Joseph C. Quigley, who died January 22, 1952 (A. 20).

Upon completion of the transfer from the decedent, Joseph C. Quigley, to his devisee, Margaret M. Quigley, on the books and records of the Telegraph-Herald and delivery to her of the certificate for the 379 shares of common stock, the transferee acquired "**PERFECT**" title to such stock. This transfer was disputed by no one. Parenthetically, such transfer was authorized by the District Court of Iowa, in and for Dubuque County as part of the probate proceedings of the decedent's Estate.

On June 9, 1960, Margaret M. Quigley, the dissenting shareholder, owned and had title in and to the same 379 shares of the common stock of the Telegraph-Herald that she acquired from her husband by bequest in 1952 (A. 3, 16, 19, 21 and 23).

It is obvious that counsel for the Commissioner of Internal Revenue considered that the dissenting shareholder's title in and to such 379 shares was "**PERFECT**" on June 9, 1960, or he would have characterized her title to such shares as being "imperfect" when drafting the stipulation of facts (A. 3).

As Judge Mellott of the U. S. Tax Court stated in **Heller v. C.I.R.**, 2 T. C. 371 (1943) (the litigation expenses involved therein having been precipitated by the taxpayer-shareholder's dissenting vote to a contemplated merger or consolidation arising under a California appraisal statute), at page 374 of 2 T. C.; to-wit:

> "THE STATUTE UNDER WHICH IT WAS INSTITUTED PRESUPPOSES THAT THE 'DISSENTING SHAREHOLDERS' OWN THE SHARES WHICH THEY ARE SEEKING TO HAVE APPRAISED."

The conclusion that Margaret M. Quigley, the dissenting shareholder, had perfect title to such stock on June 9, 1960, is inescapable. On June 9, 1960, the Taxpayers

acquired the dissenting shareholder's perfect title in and to such stock by operation of law. Accordingly, the Court of Appeal's premise that . . . **Title to the stock was perfected as a result of the Taxpayers' expenditures** . . . is demonstrably inaccurate and in error.

In the case of **Heller v. Commissioner,** 2 T. C. 371 (1943), aff'd 147 F. 2d 376 (9 Cir. 1945), cert. denied 325 U. S. 868 (1945), the issue was whether legal fees and expenses paid by a dissenting stockholder, in connection with litigation to determine the value and to enforce his rights to the cash value of his shares pursuant to a California statute providing that stockholders not consenting to a merger or consolidation were entitled to be paid such value, were deductible as expenses for the production for collection of income or in the management of property held for the production of income.

At page 372 the Court stated as follows; to-wit:

> "Respondent contends that the amount of $2,145 paid by petitioner to attorneys during 1937 should be capitalized. Petitioner contends that is is deductible as expense.
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> Section 23(a) of the Revenue Act of 1936 was amended by section 121 of the Revenue Act of 1942 to allow the deduction of non-trade and non-business expenses.
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> * * * * * * * *
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> Respondent urges that the attorneys' fee was incurred in a matter pertaining to assets of a purely capital nature; that the litigation actually involved a defense by petitioner of his rights in, and his title to, these assets; and that the expenditure, being a capital one, was not a deductible expense for 1937.
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> * * * * * * * *
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> The report of the Finance Committee which accompanied H. R. 7378 and which as amended became the

Revenue Act of 1942, in discussing the amendment to section 23(a) providing for the deduction of non-trade or non-business expenses, contains the following statement:

> 'Expenses to be deductible under section 23(a)(2) must be ordinary and necessary, which rule presupposes that they must be reasonable in amount and must bear a reasonable and proximate relation to the production or collection of income, or to the management, conservation, or maintenance of property held for that purpose.'

It is obvious from the above that Congress intended that some expenditures pertaining to assets of a purely capital nature were to be allowed as deductions from gross income. Other statements in the report clearly indicate that this is so. Thus, in referring to the term 'income' it is said that it 'comprehends not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent years, and is not confined to recurring income but applies as well to gain from the disposition of property.'

The attorneys' fee paid by petitioner, while relating to a capital asset, bore a reasonable and proximate relation to the production or collection of income, and to the management of property held for that purpose. **The litigation did not, as** respondent urges, **involve a defense by petitioner of his rights in, and his title to, the stock. The statute under which it was instituted presupposes that the 'dissenting stockholders' own the shares which they are seeking to have appraised. The litigation concerned the exercise by petitioner of his right to receive cash for his shares and the determination of the amount thereof,** he not having approved the contemplated merger or consolidation and having taken the other

steps required by the statute. As a result of that litigation the fair market value of his stock was determined and paid to him in 1938. The attorneys' fee in our judgment was paid for services rendered in connection with 'the production or collection of income,' and in connection with 'the management * * * of property held for the production of income.' Respondent therefore erred in disallowing the claimed deduction."

The decision of the Tax Court on this particular issue was affirmed on appeal by the Court of Appeals for the 9th Circuit in 147 F. 2d 376, cert. denied, at 325 U. S. 868.

The proposition of law established by the Tax Court in **Heller v. Commissioner**, 2 T. C. 371 (1943), was reaffirmed in the case of **Hilton Hotels Corp. v. United States**, 410 F. 2d 194 (7th Cir. 1969), and in the case of **Smith Hotel Enterprises, Inc. v. Nelson**, 236 F. Supp. 303 (E. D. Wis. 1964). The latter was an action brought by a corporate taxpayer for the refund of additional taxes paid when the District Director disallowed deductions taken on the corporation's 1959 income tax return for expenditures made for legal and professional services rendered in a litigation to determine the "fair value" of a dissenting shareholder's minority interest in the corporation, such action being predicated upon a Wisconsin appraisal statute.

The Court held as follows on page 304 of 236 F. Supp.; to-wit:

"The District Director disallowed the deduction claimed for the expenses incurred in the litigation with the shareholder on the ground that they were capital expenditures made for the acquisition of the shares owned by the dissenting shareholder.

The taxpayer contends that the fact that title to property may be involved in litigation does not auto-

matically render expenses incurred in that litigation non-deductible. The test established, it is argued, requires a determination of the **primary purpose** of the litigation. **Industrial Aggregate Company v. United States**, 284 F. 2d 639 (8th Cir. 1960).

The plaintiff argues that under the facts of the present case, any question of title was incidental. **Under the Wisconsin statute the corporation was required to purchase the stock of the dissenting shareholder. The only purpose of the action in Circuit Court was to determine the fair value of the shares. The taxpayer's purpose in the state litigation was to keep its liability to a minimum.**

In support of this position the taxpayer cites **Heller v. Commissioner**, 2 T. C. 371 (1943), aff'd 147 F. 2d 376 (9th Cir. 1945), cert. denied 325 U. S. 868, 65 S. Ct. 1405, 89 L. Ed. 1987, as a case directly in point. There a taxpayer was allowed to deduct litigation expenses incurred in an action he brought for a determination of the fair value of his shares in a merging company. The action was brought under a California statute giving to shareholders dissenting to merger or consolidation the same relief as the Wisconsin statute here involved. The Tax Court rejected the argument that the litigation expenses should be capitalized.

* * * * * * * *

The government urges that the deduction here was properly disallowed and relies on the case of **Boulder Building Corporation v. United States**, 125 F. Supp. 512 (W. D. Okla. 1954), to support its position. There minority shareholders dissented to the extension of the life of the corporation and an enlargement of the corporate powers. They commenced an action to fix the value of their shares under an Oklahoma statute similar to § 180.72 of the Wisconsin Statutes. The

court ruled that the litigation expenses were nondeductible because they were paid in connection with the acquisition of stock. The court distinguished the Atwater case, supra, on the ground that the focal point of that case was the legal effect of an employment contract.

Counsel for the plaintiff urges that the decision in Boulder is unsound in that it disregards the fact that the taxpayer's obligation to purchase the dissenters' stock was an **involuntary obligation.** Under the Oklahoma statute, as well as under the Wisconsin statute, once the dissenters have demanded that the corporation purchase their shares at fair value, the corporation has no choice in the matter. **After the demand has been made, the corporation's main concern is with keeping its liability to a minimum. Plaintiff's argument is sound. Viewed in this light it appears that the primary purpose of the state litigation in the instant case was a determination of the fair value of the shares, and the involvement of title was incidental.** The deduction made by the taxpayer was proper as an ordinary and necessary business expense."

The deductibility of litigation expenses incurred in actions involving corporate stock has been upheld in the following cases, analogous in respect to the application of the legal theory involved in the case at bar.

In **Naylor v. Commissioner of Internal Revenue,** 203 F. 2d 346 (5th Cir. 1953) the taxpayer owned stock in the Lane Drug Stores, Inc. He gave an option on his Lane Drug Stores, Inc. Stock to Interstate Drugs, Inc. Interstate gave notice of exercise of its option and set forth in such notice what it intended to pay taxpayer for his Lane Drug Stores, Inc. Stock. The Court, at page 346 of 203 F. 2d, stated as follows, to-wit:

"The option agreement provided that Interstate should pay for such shares so purchased the net asset value thereof as shown by the books of Lane Drug Stores, Inc., on the last day of the month preceding the date on which the purchase or sale was consummated.

The exercise on September 4, 1946, by the Company of its undisputed right to purchase petitioner's stock effectively converted the agreement of June 1, 1942, into a binding contract of sale, since it constituted an acceptance of petitioner's outstanding offer to sell; but **a dispute arose between the parties as to the net asset value of the shares** as shown by the books of Lane Drug Stores on the last day of the month preceding the date on which the purchase or sale was consummated. The option agreement repeatedly referred to the purchase or sale as being 'consummated' when the party formally exercised its right to purchase said stock.

Since the sale was consummated except as to the delivery of the stock and the payment of the purchase price, the petitioner did not need and did not employ a broker to sell his stock, but employed a lawyer to negotiate, and if necessary to sue, for the purchase money due him under the contract. The Interstate Company had previously given notice to the petitioner that it was exercising its option to buy this stock for $440,000, the asserted option price. The amount paid his attorney by the petitioner was for services leading to the petitioner receiving $580,000 for delivering his stock to the purchaser under the option. This was $140,000 above the price at which the company had purported to exercise its option."

The taxpayer deducted his legal expenditures as ordinary and necessary expenses pursuant to Section 23(a)(2) of the Internal Revenue Code of 1939, the comparable

Section in the Internal Revenue Code of 1954 is Sec. 212. The Commissioner disallowed such deduction, claiming that the legal expenses were capital expenditures incurred in the acquisition of stock. The Court in rejecting the Commissioner's contention stated as follows on page 347 of 203 F. 2d; to-wit:

> "**There was no dispute about the title to the stock or petitioner's duty to deliver it. The controversy was over the amount due him upon delivery thereof.** The situation called for the services of an attorney to collect the proceeds of a sale of a capital asset. **Petitioner's attorney was employed after an enforceable contract sale existed.**"

Likewise, in the case now before this Court, there was no dispute about the title to the stock owned by the dissenting shareholder or the majority shareholders' (Taxpayers') duty to purchase it. The controversy, in the state court litigation, was over the "real value" of the stock of the dissenting shareholder. Similarly, in the **Naylor v. C. I. R.** case the dispute arose ". . . as to the net asset value of the shares. . . ." The situation called for the services of attorneys', appraisers' and accountants' to determine the "real value" of such stock pursuant to the terms and conditions of the Iowa appraisal statute, Section 491.25 of the 1958 Code of Iowa (A. 6). **The majority shareholders' attorneys, etc. were employed,** viz., the equitable action in the District Court of Iowa in and for Dubuque County asking the Court to fix and determine the real value of the dissenting shareholders' common stock was filed on February 9, 1962, **twenty-one months after the majority shareholders were legally obligated to purchase the stock owned by the dissenting shareholder** (A. 6).

In **William C. Atwater & Co. v. Commissioner of Internal Revenue,** 10 T. C. 218 (1948), a former employee of the taxpayer company brought suit to require the repur-

chase of stock held by such employee upon the termination of his employment. The obligation to repurchase the stock was set forth on the stock certificates. The company incurred litigation expense in defending the action. The Tax Court found the litigation expense to be deductible.

The language of the Court in supporting its finding of deductibility is particularly applicable to the factual situation now before this Court. The Court therein states on page 248 of 10 T. C.:

> "**These facts in substance show that in the litigation with Steinbugler petitioner was not endeavoring to acquire any capital assets. It was not defending the title to any stock which it already owned.** On the contrary, it was strenuously resisting the suit of Steinbugler, a former employee, in the regular course of its business. The very essence of this litigation was Steinbugler's effort to enforce an employment contract to repurchase the stock at a price which Steinbugler thought he was entitled to receive. Petitioner contested both its obligation to repurchase and the amounts asked for by Steinbugler. **Title to the stock was involved only incidentally.** The fact that petitioner was the loser in this litigation and was forced to acquire the stock against its will and pay the judgment which Steinbugler obtained against it, does not, in our opinion, impair its right to deduct the litigation expenses of that suit. We hold that the amounts expended by petitioner in 1942 for legal fees and litigation expenses, all in connection with the Steinbugler litigation, are deductible in 1942 under Section 23 (a) (1) (A), supra. Cf. **Kornhauser v. United States**, 276 U. S. 145; **Welch v. Helvering**, 290 U. S. 111."

Similarly, in the case now before this Court, the majority shareholders (Taxpayers) in the state court litiga-

tion were not endeavoring to acquire the title to the stock of the dissenting shareholder—they already had a statutory obligation to purchase such stock—nor were they defending the title to stock they already owned. On the contrary, in the state court action the majority shareholders were strenuously attempting to keep their liability to a minimum. The very essence of the litigation was the dissenting shareholder's effort to obtain the highest possible value under the Iowa appraisal statute for her shares. The majority shareholders (Taxpayers) resisted and endeavored to hold the amount of the value of the shares to a minimum. Title to the stock was never involved, not even incidentally.

In **Straub v. Granger**, 143 F. Supp. 250 (D. C. Pa. 1956), the Court stated, at page 252, the issue for determination as follows; to-wit:

> ". . . whether amounts expended by taxpayers as attorneys fees are deductible under Section 23 (a) (2) of the Internal Revenue Code of 1939 as amended, 26 U. S. C. A., as ordinary and necessary expenses for the management, conservation or maintenance of income-producing property . . ."

The Court's holdings appear on pages 253 and 254 as follows, to-wit:

> "16. **The main and primary purpose of taxpayers in obtaining legal advice was to protect their existing investment** in the Fort Pitt Bridge Works.
>
> 17. **Expenditures of taxpayers for the legal services in controversy were not made for the purpose of acquiring stock** but were ordinary and necessary expenses incurred in the management, conservation or maintenance of income-producing property."

Likewise, in the case at bar, the main and primary purpose of the majority shareholders (Taxpayers) in ob-

taining legal advise and in commencing the state court litigation out of which the expenses in question arose was to conserve, maintain and protect investment properties which they held for the production of income. To effectuate this purpose the majority shareholders made every effort to minimize the value placed upon the dissenting shareholder's stock in the state court litigation. The acquisition of the title to the common stock of the Telegraph-Herald owned by the dissenting shareholder was never involved, not even remotely. The legal obligation imposed upon the majority shareholders (Taxpayers) to acquire or to purchase such stock arose at the special meeting of the common stock shareholders of the Telegraph-Herald on June 9, 1960 (A. 9).

The Court's rationale for its determination in the **Straub v. Granger** case is stated as follows on pages 254 and 255 of 143 F. Supp.; to-wit:

> "The Court thinks the weight of the arguments is in plaintiff's favor. There are two difficulties with defendant's position. **First of all, it confuses the nature of taxpayers' original request of counsel with the form of the advice which was given.** The question of acquiring stock control, or perfecting title to the stock, did not originate with the Straubs but came into being only after they were told by counsel they could maintain their position in the company in that manner. It can not be doubted that the subsequent dealings of James M. Straub with counsel contributed to the end result of taxpayers' obtaining additional shares of stock, **but nevertheless, title to the stock eventually acquired was not perfected by their expenditures for legal services.** On the whole, the court is satisfied that such subsequent conferences and legal services are regarded properly in relation to the purpose for which taxpayers obtained counsel rather than to the increased ownership which resulted. **What**

was involved essentially was the rendition of advice as to a method in which they could protect their investment in the company and as to the manner in which that could be done. Cf. Bagley v. Commissioner, 1947, 8 T. C. 130, 132-133.

Secondly, the cases have established a well-defined exception to the rules defendant contends for, which depends upon a determination, where questions of defending or perfecting title to property may be involved, of what the main and primary purpose of the taxpayer has been in incurring the legal, or other, expenses in issue . . . (Citations omitted). . . . Courts have been cautioned that, in tax matters, the form of a transaction is not to prevail over its substance. **Urquhart v. Commissioner,** supra, 215 F. 2d at page 19. **Accordingly, the fact that taxpayers' ownership in the corporation was increased partly through the services of counsel does not establish that counsel was paid for acquiring stock. If counsel was retained in the manner in which he was because the Straubs feared their investment was unsafe in the control of the existing management, payment to counsel was not part of the cost of property acquired."**

It is respectfully submitted that a perusal of the facts herein and an application of the "primary purpose test" thereto makes the conclusions reached by Judge Bruce in his dissenting opinion inevitable (A. 42); to-wit:

"The case of **Woodward v. Quigley,** supra, was brought to resolve such a purely private right between the majority and dissenting stockholders. The corporation was not a party thereto and the action did not involve its business operations. The stock which petitioners owned in Telegraph-Herald was held by them for investment purposes and the extension of the life of the corporation was necessary to the management, conservation, or maintenance of such property. The majority stockholders

recognized their obligation under the Iowa statute to purchase the stock of the dissenting stockholder. The majority stockholders were interested in minimizing the value of the stock whereas the dissenting stockholder was interested in a high valuation. Being unable to agree upon the "real value" of the stock in question, the primary, and, in fact, the only purpose of the litigation was to obtain a court determination of the real value of the stock. Neither a money judgment nor the enforcement of a contract or statutory obligation was sought or determined. Title to the stock was never in question, and was only incidentally involved." (Footnotes omitted.)

CONCLUSION

For the reasons stated it is requested that the Supreme Court of the United States grant the following relief; to-wit:

(a). That the judgment of the Court of Appeals be reversed and a determination made that the Taxpayers are not deficient in their income tax payments for the taxable year 1963; and,

(b). That the Taxpayers, Fred W. Woodward and Elsie M. Woodward, are entitled to a refund for overpayment of their 1963 income tax in the amount of $1,134.47 or such other amount plus interest which is legally refundable (A. 8).

Respectfully submitted

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STATUTES, REGULATIONS AND LEGISLATIVE HISTORY.

STATUTES.

Internal Revenue Code of 1939

"Sec. 23. Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

(a) Expenses.—

(1) Trade or business expenses.—

(A) In general.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity. In the case of any sports program conducted for the benefit of the American National Red Cross, expenses described in section 22 (b) (16) (B) shall be allowable under this subparagraph only to the extent that such expenses exceed the amount ex-

cluded from gross income by section 22 (b) (16)."

* * * * * * * *

Note: Sec. 23(a)(1)(A) of 1939 IRC is comparable to Sec. 162(a) of 1954 IRC.

Internal Revenue Code of 1939

"Sec. 23 Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

(a) Expenses.—

* * * * * * * *

(2) Non-trade or non-business expenses.—In the case of an individual, all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income."

* * * * * * * *

Note: Sec. 23(a)(2) of 1939 IRC is comparable to Sec. 212 of 1954 IRC.

Internal Revenue Code of 1939

"Sec. 24. Items Not Deductible.

(a) General Rule.—In computing net income no deduction shall in any case be allowed in respect of—

(2) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate, except expenditures for the development of mines or deposits deductible under section 23(cc); . . ."

* * * * * * * *

Note: Sec. 24(a)(2) of 1939 IRC is comparable to Sec. 263(a)(1) and (2) of 1954 IRC.

Internal Revenue Code of 1954

"Sec. 162. Trade or Business Expenses.

(a) In General.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

* * * * * * * *

Note: Sec. 162(a) of 1954 IRC is comparable to Sec. 23(a)(1)(A) of 1939 IRC.

Internal Revenue Code of 1954.

"Sec. 212. Expenses for Production of Income.

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—

(1) for the production or collection of income;

(2) for the management, conservation, or maintenance of property held for the production of income; or

(3) in connection with the determination, collection, or refund of any tax."

Note: Sec. 212 of 1954 IRC is camparable to Sec. 23(a)(2) of 1939 IRC.

Internal Revenue Code of 1954.

"Sec. 263. Capital Expenditures.

(a) General Rule.—No deduction shall be allowed for—

(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. This paragraph shall not apply to—

(A) expenditures for the development of mines or deposits deductible under section 616,

(B) research and experimental expenditures deductible under section 174,

(C) soil and water conservation expenditures deductible under section 175,

(D) expenditures by farmers for fertilizer, etc., deductible under section 180, or

(E) expenditures by farmers for clearing land deductible under section 182.

(2) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made."

• • • • • • • •

Note: Sec. 263(a)(1) and (2) of 1954 IRC are comparable to Sec. 24(a) of 1939 IRC.

REGULATIONS.

Promulgated Pursuant to IRC of 1939.

"Sec. 39.24(a)-2 Capital Expenditures.

(a) Expenditures except non-depreciable mine development expenditures. Amounts paid for increasing the capital value or for making good the depreciation (for which a deduction has been made) of property are not deductible from gross income. See section 23(1). Amounts expended for securing a copyright and plates, which remain the property of the person making the payments, are investments of capital. The cost of defending or perfecting title to property constitutes a part of the cost of the property and is not a deductible expense. The amount expended for architects' services is part of the cost of the building. Commissions paid in purchasing securities are a part of the cost price of such securities. Commissions paid in selling securities are an offset against the selling price, except that in the case of dealers in securities such commissions may be treated as an ordinary and necessary business expense. Amounts to be assessed and paid under an agreement between bondholders or shareholders of a corporation to be used in a reorganization of the corporation, are investments of capital and not deductible for any purpose in returns of income. See Sec. 39.22(a)-16. An assesment paid by a shareholder of a national bank on account of his statutory liability is ordinarily not deductible but, subject to the provisions of the Internal Revenue Code, may in certain cases represent a loss. Expenses of the organization of a corporation, such as incorporation fees, attorneys' and accountants' charges, are capital expenditures and not deductible from gross income. A holding company which guarantees dividends at

a specified rate on the stock of a subsidiary corporation for the purpose of securing new capital for the subsidiary and increasing the value of its stock holdings in the subsidiary may not deduct amounts paid in carrying out this guaranty in computing its net income, but such payments may be added to the cost of its stock in the subsidiary."

• • • • • • • •

Promulgated Pursuant to IRC of 1954.

"Sec. 1.162-1 Business Expenses.

(a) In general. Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except items which are used as the basis for a deduction or a credit under provisions of law other than section 162."

• • • • • • • •

"Sec. 1.212-1. Non-Trade or Non-Business Expenses.

(a) *An expense may be deducted under section 212 only if—*

(1) *It has been paid or incurred by the Taxpayer during the taxable year* (i) for the production or collection of income which, if and when realized, will be required to be included in income for Federal income tax purposes, or (ii) *for the management, conservation, or maintenance of property held for the production of such income,* or (iii) in connection with the determination, collection, or refund of any tax; and

(2) *It is an ordinary and necessary expense for any of the purposes stated in subparagraph (1) of this paragraph.*

(b) *The term 'income' for the purpose of section 212 includes not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years; and is not confined to recurring income but applies as well to gains from the disposition of property.* For example, if defaulted bonds, the interest from which if received would be includible in income, are purchased with the expectation of realizing capital gain on their resale, even though no current yield thereon is anticipated, ordinary and necessary expenses thereafter paid or incurred in connection with such bonds are deductible. Similarly, ordinary and necessaary expenses paid or incurred in the management, conservation, or maintenance of a building devoted to rental purposes are deductible notwithstanding that there is actually no income therefrom in the taxable year, and regardless of the manner in which or the purpose for which the property in question was acquired. *Expenses paid or incurred in managing, conserving, or maintaining property held for investment may be deductible under section 212 even though the property is not currently productive and there is no likelihood that the property will be sold at a profit or will otherwise be productive of income and even though the property is held merely to minimize a loss with respect thereto.*

* * * * * * * *

(d) *Expenses, to be deductible under section 212, must be 'ordinary and necessary'. Thus, such expenses must be reasonable in amount and must bear a reasonable and proximate relation to the production or collection of taxable income or to the management, conservation, or maintenance of property held for the production of income.*

(e) A deduction under section 212 is subject to the restrictions and limitations in part IX (section 261 and following), subchapter B, chapter 1 of the Code, relating to items not deductible. Thus, no deduction is allowable under section 212 for any amount allocable to the production or collection of one or more classes of income which are not includible in gross income, or for any amount allocable to the management, conservation, or maintenance of property held for the production of income which is not included in gross income. See section 265. Nor does section 212 allow the deduction of any expenses which are disallowed by any of the provisions of subtitle A of the Code, even though such expenses may be paid or incurred for one of the purposes specified in section 212.

(k) Expenses paid or incurred in defending or perfecting title to property, in recovering property (other than investment property included in gross income), or in developing or improving property, constitute a part of the cost of the property and are not deductible expenses. Attorneys' fees paid in a suit to quiet title to lands are not deductible; but if the suit is also to collect accrued rents thereon, that portion of such fees is deductible which is properly allocable to the services rendered in collecting such rents. Expenses paid or incurred in protecting or asserting one's right to property of a decedent as heir or legatee, or as beneficiary under a testamentary trust, are not deductible.

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(m) An expense (not otherwise deductible) paid or incurred by an individual in determining or contesting a liability asserted against him does not become deductible by reason of the fact

that property held by him for the production of income may be required to be used or sold for the purpose of satisfying such liability.

(n) Capital expenditures are not allowable as non-trade or non-business expenses. The deduction of an item otherwise allowable under section 212 will not be disallowed simply because the taxpayer was entitled under subtitle A of the Code to treat such item as a capital expenditure, rather than to deduct it as an expense. For example, see section 266. Where, however, the item may properly be treated only as a capital expenditure or where it was properly so treated under an option granted in subtitle A of the Code, no deduction is allowable under section 212; and this is true regardless of whether any basis adjustment is allowed under any other provision of the Code."

* * * * * * * *

"Sec. 1.263 (a)-2 Examples of Capital Expenditures.

The following paragraphs of this section include examples of capital expenditures:

(a) The cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year."

* * * * * * * *

"(c) The cost of defending or perfecting title to property."

* * * * * * * *

"(e) Commissions paid in purchasing securities. Commissions paid in selling securities are an offset against the selling price, except that in the case of dealers in securities such commissions

may be treated as an ordinary and necessary business expense."

• • • • • • • •

LEGISLATIVE HISTORY.

Revenue Act of 1942: HOUSE REPORT No. 2333, 77th Congress, 2nd Session (1942); 1942-2 C.B. 372.

At page 410 of 1942-2 C.B.:

"6. Nontrade or Nonbusiness Deductions.

The existing law allows taxpayers to deduct expenses incurred in connection with a trade or business. Due partly to the inadequacy of the statute and partly to court decisions, nontrade or nonbusiness expenses are not deductible, although nontrade or nonbusiness income is fully subject to tax. The bill corrects this inequity by allowing all of the ordinary and necessary expenses paid or incurred for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income. Thus, whether or not the expense is in connection with the taxpayer's trade or business, if it is expended in the pursuit of income or in connection with property held for the production of income, it is allowable."

At pages 429 and 430 of 1942-2 C.B.:

"Section 118. Nontrade or Nonbusiness Deductions.

This amendment allows a deduction for the ordinary and necessary expenses of an individual paid or incurred during the taxable year for the production and collection of income, or for the management, conservation, or maintenance of property held by the taxpayer for the production of income, whether or not such expenses are paid or

incurred in carrying on a trade or business, and also allows a deduction for the exhaustion and wear and tear (including a reasonable amount for obsolescence) on property held for the production of income, whether or not such property is used by the taxpayer in a trade or business.

For an expense to be deductible under this section, it must have been incurred either (1) for the production or collection of income, or (2) for the management, conservation, or maintenance of property held for the production of income. *Ordinary and necessary expenses so paid or incurred are deductible under section 23(a)(2) even though they are not paid or incurred for the production or collection of income of the taxable year or for the management, conservation, or maintenance of property held for the production of such income. The term 'income' for this purpose comprehends not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years, and is not confined to recurring income but applies as well to gain from the disposition of property. Expenses incurred in managing or conserving property held for investment may be deductible under this provision even though there is no likelihood that the property will be sold at a profit or will otherwise be productive of income.* The expenses, however, of carrying on a transaction which does not constitute a trade or business of the taxpayer and is not carried on for the production of income or for the management, conservation, or maintenance of property, but which is carried on primarily as a sport, hobby, or recreation are not allowable as nontrade or nonbusiness expenses.

Expenses, to be deductible under section 23(a)(2) must be ordinary and necessary, which rule presupposes that they must be reasonable in amount and must bear a reasonable and proximate relation to the production or collec-

tion of income, or to the management, conservation, or maintenance of property held for that purpose.

A deduction under this section is subject, except for the requirement of being incurred in connection with a trade or business, to all the restrictions and limitations that apply in the case of the deduction under section 23(a)(1)(A) of an expense paid or incurred in carrying on any trade or business. Section 24(a)(5), as amended by this section, while continuing to disallow any amount allowable as a deduction, whether under section 23(a)(2) or otherwise, which is allowable to one or more cases of tax-exempt income, other than interest, has the effect in addition of disallowing a deduction under section 23(a)(2) for amounts allowable under that section which are allocable to tax-exempt interest.

Expenses incurred by an administrator or executor in the administration of the estate of a decedent, such, for example, as expenses in securing the processes and orders of the court having jurisdiction over the probate of an estate, or in adjusting claims against the estate, or in distributing the remaining assets to the beneficiaries, are not deductible under this section. Ordinary and necessary expenses, however, which are paid or incurred during the taxable year by an administrator or an executor for the production or collection of income which must be reported by the estate for income tax purposes, may be claimed as deductions under this section notwithstanding that deductions therefor are allowable under section 812(b) in computing the gross estate subject to the estate tax. Accordingly, subsection (c) of this section amends section 162 to provide that no deduction shall be allowed under section 23(a)(2) in computing the net income of the estate for amounts for which there may have been or has already been allowed a deduction under section 812(b) in computing the net estate of the decedent. The present amendment would not allow as a deduction under section

23(a)(2) for income tax purposes any amount which is allowable under section 812(b) as a deduction in computing the net estate of a decedent for estate tax purposes, unless the Commissioner receives a statement, filed within the time and in the manner and form prescribed by him, to the effect that the amount in question has not been claimed or allowed as a deduction under section 812(b) and that the right to have such items allowed at any time as a deduction under section 812(b) is waived.

Subsection (d) of this section amends 23(1) of the Internal Revenue Code so as to allow, in addition to the deduction allowable under the existing law, a deduction for the exhaustion, wear and tear of property held by the taxpayer for the production of income, whether or not the property in question is used in the trade or business of the taxpayer, including a reasonable allowance for obsolescence. Except for this, the new allowance is subject to the same limitations and restrictions which have been applicable under this section prior to the present amendment.

The amendments made to the Internal Revenue Code by this section are applicable to all taxable years beginning after December 31, 1938. These amendments shall also be effective as if they were a part of the Revenue Act of 1938 or any prior Revenue Act on the date of its enactment."

Revenue Act of 1942: SENATE REPORT No. 1631, 77th Congress, 2nd Session (1942); 1942-2 C.B. 504.

At page 570 of 1942-2 C.B.:

"Section 121. Non-Trade or Non-Business Deductions.

This section is the same as section 118 of the House bill, except that subsection (c) of that section has been omitted therefrom and now appears as section 163 and a clerical amendment has been made in subsection (b). The amend-

ment made by this section allows a deduction for the ordinary and necessary expenses of an individual paid or incurred during the taxable year for the production and collection of income, or for the management, conservation, or maintenance of property held by the taxpayer for the production of income, whether or not such expenses are paid or incurred in carrying on a trade or business, and also allows a deduction for the exhaustion and wear and tear (including a reasonable amount for obsolescence) on property held for the production of income, whether or not such property is used by the taxpayer in a trade or business.

For an expense to be deductible under this section, it must have been incurred either (1) for the production or collection of income, or (2) *for the management, conservation, or maintenance of property held for the production of income. Ordinary and necessary expenses so paid or incurred are deductible under section 23(a)(2) even though they are not paid or incurred for the production or collection of income of the taxable year or for the management, conservation, or maintenance of property held for the production of such income. The term 'income' for this purpose comprehends not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years, and is not confined to recurring income but applies as well to gain from the disposition of property.* Expenses incurred in managing or conserving property held for investment may be deductible under this provision even though there is no likelihood that the property will be sold at a profit or will otherwise be productive of income, and even though the property is held merely to minimize a loss with respect thereto. The expenses, however, of carrying on a transaction which does not constitute a trade or business of the taxpayer and is not carried on for the production of income or for the management, conservation, or maintenance of property, but which is carried on primarily

as a sport, hobby, or recreation are not allowable as non-trade or non-business expenses.

Expenses, to be deductible under section 23(a)(2), must be ordinary and necessary, which rule presupposes that they must be reasonable in amount and must bear a reasonable and proximate relation to the production or collection of income, or to the management, conservation, or maintenance of property held for that purpose.

A deduction under this section is subject, except for the requirement of being incurred in connection with a trade or business, to all the restrictions and limitations that apply in the case of the deduction under section 23 (a)(1)(A) of an expense paid or incurred in carrying on any trade or business. Section 24(a)(5), as amended by this section, while continuing to disallow any amount allowable as a deduction, whether under section 23(a)(2) or otherwise, which is allocable to one or more classes of tax-exempt income, other than interest, has the effect in addition of disallowing a deduction under section 23(a)(2) for amounts allowable under that section which are allocable to tax-exempt interest.

Subsection (c) of this section amends section 23(l) of the Code so as to allow, in addition to the deduction allowable under the existing law, a deduction for the exhaustion, wear, and tear of property held by the taxpayer for the production of income, whether or not the property in question is used in the trade or business of the taxpayer, including a reasonable allowance for obsolescence. Except for this, the new allowance is subject to the same limitations and restrictions which have been applicable under this section prior to the present amendment.

The amendments made to the Code by this section are applicable to all taxable years beginning after December 31, 1938. These amendments shall also be effective as if they were a part of the Revenue Act of 1938 or any prior Revenue Act on the date of its enactment."

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In the Supreme Court of the United States

OCTOBER TERM, 1969

No. 412

FRED W. WOODWARD AND ELSIE M. WOODWARD, F. R. WOODWARD AND M. JEANNE WOODWARD, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

No. 528

UNITED STATES OF AMERICA, PETITIONER

v.

HILTON HOTELS CORPORATION

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE COMMISSIONER AND THE UNITED STATES

OPINIONS BELOW

No. 412. The findings of fact and opinion of the Tax Court (R. 28–47)[1] are reported at 49 T.C. 377.

[1] "R." refers to the record appendix in No. 412, *Woodward* v. *Commissioner*.

The opinion of the court of appeals (R. 49–63) is reported at 410 F. 2d 313.

No. 528. The opinion of the district court (528–R. 33–36)[2] is reported at 285 F. Supp. 617. The opinion of the court of appeals (528–R. 37–41) is reported at 410 F. 2d 194.

JURISDICTION

No. 412. The judgment of the court of appeals was entered on May 2, 1969 (R. 64). The petition for a writ of certiorari was filed on July 31, 1969, and certiorari was granted on October 20, 1969 (R. 65). The jurisdiction of this Court rests on 28 U.S.C. 1254 (1).

No. 528. The judgment of the court of appeals was entered on April 15, 1969 (528–R. 42). By order dated June 30, 1969, Mr. Justice Stewart extended the time for filing a petition for a writ of certiorari to and including August 28, 1969. The petition was filed on that day, and certiorari was granted on December 8, 1969 (528–R. 43). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether, for federal income tax purposes, expenditures incurred in connection with an appraisal proceeding to fix the value of dissenting shareholders' stock are deductible as ordinary and necessary expenses relating to property held for the production of income or as ordinary and necessary business expenses, or are nondeductible capital outlays.

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[2] "528–R." refers to the record appendix in No. 528, *United States* v. *Hilton Hotels Corporation.*

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 162, 212 and 263 of the Internal Revenue Code of 1954 and Sections 1.212–1(n) and 1.263(a)–2 of the Regulations thereunder are set forth in the Appendix, *infra*, pp. 28–31.

STATEMENT

Factually, these cases present several common features: (1) a course of action voted upon by a requisite number of a corporation's shareholders, to which certain shareholders dissented; (2) a requirement under state law that the dissenting shareholders' stock be purchased at its fair value; (3) an appraisal proceeding to fix the fair value of the dissenters' shares; and (4) the expenditure of legal and related fees by the purchaser of the dissenters' shares in connection with the appraisal proceeding. In No. 412, the Eighth Circuit has held that these expenditures are nondeductible capital outlays; while the Seventh Circuit in No. 528 has held them to be deductible.

No. 412. As of June 9, 1960, petitioners [3] owned directly 511 of the 1,200 outstanding shares of the common stock of the Telegraph-Herald, a corporation organized under the laws of the State of Iowa. Petitioners Elsie M. Woodward and M. Jeanne Woodward were trustees of two trusts which owned a total

[3] Petitioners Elsie M. Woodward and M. Jeanne Woodward are the wives of petitioners Fred W. Woodward and F. R. Woodward, respectively, and are parties to this action solely because they filed joint returns with their husbands (R. 29).

of 300 additional shares. Originally incorporated in 1901, the Telegraph-Herald was engaged in publishing a daily newspaper and operating a commercial printing plant and radio station. Its corporate existence was renewed in 1921 and 1941. Under the 1941 renewal, its life was extended for 20 years to November 1, 1961. (R. 29–30.)

On June 9, 1960, the common stockholders of the Telegraph-Herald held a special meeting for the purpose of further extending its corporate charter. A resolution was adopted by the holders of a majority of the stock under which the corporate life was extended in perpetuity. Thereafter, on or about June 10, 1960, the Secretary of State for the State of Iowa issued a certificate for the renewal of the Telegraph-Herald's corporate charter. (R. 30.)

Of the 1,200 outstanding shares of Telegraph-Herald common stock, 811 shares owned or controlled by petitioners and 10 shares owned by the Estate of Ellen Murphy were voted in favor of renewal of the corporate existence. The remaining 379 shares owned by Margaret M. Quigley were voted against renewal. Because Iowa law (Iowa Code Ann. (1969 Cum. Ann. Pocket Pt.) Sec. 491.25) required "those stockholders voting for such renewal * * * [to] purchase at its real value the stock voted against such renewal * * *," petitioners, as the majority stockholders, attempted to reach agreement with Margaret M. Quigley as to the "real value" of her stock. This effort was unsuccessful. Accordingly, on February 9, 1962, petitioners filed a petition in equity in the District Court of Iowa

(Dubuque County) requesting a determination of the real value of Margaret M. Quigley's stock.[4] A decision was entered by the district court on May 18, 1963, establishing a value of $1,750 per share. On appeal to the Supreme Court of Iowa (*Woodward* v. *Quigley,* 257 Iowa 1077, 133 N.W. 2d 38), that court determined the real value of Margaret M. Quigley's shares to be $1,650 per share. On rehearing (257 Iowa 1077, 136 N.W. 2d 280), the court fixed the real value at $1,620 per share. (R. 31–32.)

On July 16, 1965, following the entry of final judgment in *Woodward* v. *Quigley,* petitioners purchased Margaret M. Quigley's 374 shares of stock[5] as required by Iowa law (R. 32–33).

During 1963, petitioners paid attorneys', accountants' and appraisers' fees, costs and disbursments in the total amount of $25,733.74 for services rendered in connection with the determination of the real value of Mrs. Quigley's stock (R. 33–34).

Petitioners claimed deductions for this amount which the Commissioner disallowed "because the fees represent capital expenditures incurred in connection with the acquisition of capital stock of a corporation * * *" (R. 34). The Tax Court sustained the Commissioner's determination that the expenditures

[4] All of the majority shareholders, with the exception of the Estate of Ellen Murphy, participated in the state court proceedings (R. 32).

[5] Petitioners purchased the shares as follows: Fred W. Woodward—184 shares; F. R. Woodward—27 shares; M. Jeanne Woodward—25 shares; and the two trusts—138 shares. The remaining five shares were purchased by the Estate of Ellen Murphy. (R. 33.)

were not deductible on the ground that the "value-setting litigation and its attendant expenses were directly tied to the stock purchase and the expenses were part of the cost of the stock" (R. 36). On petitioners' appeal, the Eighth Circuit affirmed, holding (R. 63) that "the transaction involved the purchase of capital assets." In so concluding, the court of appeals rejected the contention that the appraisal proceeding was an event separate and distinct from the stock purchase and essentially disapproved the approach taken by the Seventh Circuit in No. 528. It observed (*ibid.*) that "The valuation of those assets [Mrs. Quigley's shares] was vital to the purchase, and the litigation necessary for valulation was thus inextricably woven into the fabric of the overall transaction."

This Court granted the taxpayers' petition for certiorari on October 20, 1969 (R. 65).

No. 528. In September 1953, Hilton Hotels Corporation ("Hilton") owned 325,370.5 of the 366,040.75 issued shares of Hotel Waldorf-Astoria Corporation ("Waldorf"). In August 1953, Hilton retained Standard Research Consultants, Inc., to prepare a merger study to determine the number of Hilton shares that would be a fair basis for an exchange for the 40,670.25 outstanding Waldorf shares not held by Hilton. The final report submitted by Standard Research in October 1953 concluded that Hilton would be justified in offering 1.25 shares of its common stock for each share of Waldorf stock as a fair basis of merger. (528–R. 5–6.)

On November 12, 1953, Hilton and Waldorf entered into an agreement of merger which provided that Hilton would be the surviving corporation and 1.25 shares of Hilton stock would be offered for each outstanding Waldorf share not held by Hilton. Subsequently, on December 28 and 29, 1953, the holders of more than two-thirds of the stock of Hilton and Waldorf voted to approve the merger. Prior to the vote, the holders of 20,221 Waldorf shares, pursuant to Section 91 of the New York Stock Corporation Law, filed with Waldorf their written objections to the merger and demanded payment for their stock. Thereafter, on December 31, 1953, the merger agreement and the certificate of consolidation were filed and recorded with the Secretary of State of New York, pursuant to Section 91 of the New York Stock Corporation Law. (528–R. 6–7.)

On January 7, 1954, Hilton offered to the dissenting holders of the 20,221 Waldorf shares a payment of $24.54 per share. The offer was rejected and the dissenting shareholders began proceedings, pursuant to Section 21 of the New York Stock Corporation Law, in the Supreme Court of New York (New York County) for a determination of the value of their Waldorf shares. (528–R. 7–8.)

During the period January through May, 1954, Hilton asked Standard Research to value the Waldorf common stock as of December 27, 1953, the day prior to the shareholders' vote approving the merger. This valuation study included the preparation of charts and tables supporting its opinion and the giving of

testimony in the appraisal proceeding. Hilton also obtained the services of lawyers, and other professional services, in connection with the appraisal proceeding. Ultimately, the appraisal proceeding was terminated by order of the New York County Supreme Court on June 14, 1955, upon its approval of the parties' settlement.[6] (528–R. 8–9.)

Hilton deducted $17,500 paid to Standard Research and $39,758.62 in other fees relating to the appraisal proceeding, which the Commissioner disallowed (528–R. 5, 10, 35). The sole issue litigated in the subsequent refund action in the district court was whether these amounts were nondeductible capital outlays, as the government contended, or were immediately deductible ordinary and necessary business expenses, as Hilton urged. Hilton conceded—and the district court held—that so much of the payment to Standard Research as pertained to the pre-merger determination of a fair basis of merger between Waldorf and Hilton could not be currently deducted. This holding was based on the established rule that expenses incurred in connection with a corporate reorganization are nondeductible capital outlays. (528–R. 33.) The district court concluded, however, that the fees and costs relating to the appraisal proceeding were currently deductible (528–R. 36). On appeal, the Seventh Circuit

[6] The settlement provided for payment of five-eighths of a share of Hilton stock for each share of Waldorf stock, but without any fractional shares issued. In addition, Hilton was to pay $6 for each one-eighth share of Hilton common stock which would have otherwise been required to be issued as a fractional share. (528–R. 9.)

affirmed (528–R. 37–41), holding that since, under New York law, the merger became effective and title to the dissenters' shares passed to Hilton in advance of the appraisal proceeding, "the expenses experienced by Hilton in connection with such proceedings were not capital in nature and were therefore deductible as ordinary and necessary business expenses" (528–R. 40).

The government's petition for certiorari was granted on December 8, 1969 (528–R. 43).

ARGUMENT

INTRODUCTION AND SUMMARY

The federal income tax law has long made the distinction between expenses that are currently deductible against income and expenditures which must be capitalized. So far as relevant here, Section 162(a) of the Internal Revenue Code of 1954, under which Hilton claimed deduction for its appraisal expenses, provides that a deduction shall be allowed for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." Section 212, which is the basis for Woodward's claim, provides that, "In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year * * * (2) for the management, conservation, or maintenance of property held for the production of income * * *."

The effect of these two provisions is to allow the deduction of only such expenses as relate to profit-seek-

ing activities—whether or not in a trade or business—rather than personal activities. However, the goal of profit-making is not enough to render the expense deductible. Section 263 must also be surmounted. It forbids a current deduction under language—captioned "Capital expenditures"—which has been unchanged since 1913[7]: "[a]ny amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate." If an expenditure falls within the scope of this statutory description, it is taken into account as a part of the cost of the property, and, unless the property is subject to depreciation or amortization, its cost is recoverable only when the property ultimately is sold or disposed of in a taxable transaction.

Capital expenditures are usually defined as those outlays made to acquire a tangible or intangible asset or benefit with a useful life of more than one year. See, *e.g.*, *Wells-Lee* v. *Commissioner*, 360 F. 2d 665 (C.A. 8); *Teitelbaum* v. *Commissioner*, 294 F. 2d 541 (C.A. 7), certiorari denied, 368 U.S. 987; *United States* v. *Akin*, 248 F. 2d 742 (C.A. 10), certiorari denied, 355 U.S. 956. Since the costs incurred in connection with the acquisition of a capital asset, *e.g.*, legal, accounting, brokerage and other similar expenses, are part of the cost of acquiring the asset, such outlays constitute capital expenditures, to be added to the cost basis of the asset for purposes of computing gain or loss on disposition. See, *e.g.*, *Helvering* v. *Win-*

[7] See Section II (B) of the Income Tax Act of 1913, c. 16, 38 Stat. 114, 167.

mill, 305 U.S. 79; *Godfrey* v. *Commissioner,* 335 F. 2d 82 (C.A. 6), certiorari denied, 379 U.S. 966; *Spangler* v. *Commissioner,* 323 F. 2d 913 (C.A. 9); *United States* v. *St. Joe Paper Co.,* 284 F. 2d 430 (C.A. 5); *Atzingen-Whitehouse Dairy, Inc.* v. *Commissioner,* 36 T.C. 173.

Costs incurred in connection with a corporate reorganization also are subject to capital treatment. As in the case of costs incurred in the acquisition of capital assets, reorganization expenses are capitalized because they are part of the cost of the reorganization and, as such, provide a benefit extending beyond the year in which they are incurred. See, *e.g., General Bancshares Corp.* v. *Commissioner,* 326 F. 2d 712, 715 (C.A. 8), certiorari denied, 379 U.S. 832; *Missouri-Kansas Pipe Line Co.* v. *Commissioner,* 148 F. 2d 460, 462 (C.A. 3); *Skenandoa Rayon Corp.* v. *Commissioner,* 122 F. 2d 268, 271 (C.A. 2), certiorari denied, 314 U.S. 696; *Motion Picture Capital Corp.* v. *Commissioner,* 80 F. 2d 872 (C.A. 2); *Odorono Co.* v. *Commissioner,* 26 B.T.A. 1355.

There is no dispute between the parties regarding the existence of these basic rules of federal income taxation. The sole question is whether these rules apply to the appraisal expenses incurred by Woodward and Hilton. The principal contention of both Hilton and Woodward as the cases reach this Court is that these rules do not apply because, under state law, title to the dissenters' shares passed to the purchasers in advance of the appraisal proceedings. Our position is that it makes no difference for federal in-

come tax purposes whether the passage of title precedes or follows the appraisal proceeding under local law. Regardless of the timing sequence of these events, the appraisal expenses are a part of the cost of acquisition of the dissenters' shares and, as such, must be capitalized.

I. THE APPRAISAL EXPENSES IN QUESTION ARE CAPITAL EXPENDITURES

Two decisions of this Court show the way to the conclusion that the appraisal expenses incurred by Woodward and Hilton are nondeductible capital outlays. These are *Helvering* v. *Winmill,* 305 U.S. 79, and *United States* v. *Gilmore,* 372 U.S. 39.

In *Winmill,* this Court approved longstanding Treasury Regulations to the effect that brokerage commissions paid in connection with the purchase of securities are not deductible, but must be added to the cost basis of the securities.[8] See Treasury Regulations (1954 Code), Section 1.263(a)–2(e), Appendix, *infra,* p. 30. It held unanimously (305 U.S. at 84) that the commissions "constituted a part of the acquisition cost of the securities" even if paid by a person in the trade or business of buying and selling securities.

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[8] Other applications of the *Winmill* rationale, that expenses incurred in connection with the acquisition of an asset are to be capitalized, are *Iowa Southern Utilities Co.* v. *Commissioner,* 333 F. 2d 382 (C.A. 8) (litigation fees in connection with shareholders' derivative suit); *Spangler* v. *Commissioner,* 323 F. 2d 913 (C.A. 9) (litigation fees incurred by minority shareholders to recover damages from corporation for fraudulent inducement of sale of their stock); *Brown* v. *Commissioner,* 215 F. 2d 697 (C.A. 5) (litigation expenses relating to will contest); *Garrett* v. *Crenshaw,* 196 F. 2d 185 (C.A. 4) (legal fees paid in suit to establish trust over property); *Addison* v. *Commis-*

For purposes of characterization as expense or capital items, the appraisal expenses incurred by Woodward and Hilton cannot be distinguished from the commissions involved in *Winmill*. Both types of expenses were incurred as a part of the process of acquisition of shares of stock. The various appraisal costs of Woodward and Hilton were expended in determining the acquisition price of the capital assets themselves; the brokerage fees in *Winmill* were a function of an agreed acquisition price.

Hilton attempts to avoid the brokerage fee analogy, without citation of *Winmill*, on the ground that (Br. in Opp. 8, n. 23) "expenses incurred for the valuation of acquired stock differ substantially from brokerage fees arising as *part* of a transaction of acquiring or selling stock." But this Court did not hold that the brokerage fees in *Winmill* were to be capitalized because they arose "as *part* of a transaction of acquiring or selling stock." It held (305 U.S. at 84) that the fees were to be capitalized because they "constituted a part

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sioner, 177 F. 2d 521 (C.A. 8) (legal fees paid in action to have sale of securities set aside); *Bowers* v. *Lumpkin*, 140 F. 2d 927 (C.A. 4), certiorari denied, 322 U.S. 755 (litigation expenses in connection with defense of action to set aside taxpayer's purchase of stock).

Similarly, the corollary of *Winmill*, that expenses incurred in connection with the sale of an asset are not currently deductible but must be offset against the proceeds of sale, is well established. *Spreckels* v. *Commissioner*, 315 U.S. 626; *Godfrey* v. *Commissioner*, 335 F. 2d 82 (C.A. 6), certiorari denied, 379 U.S. 966; *Munson* v. *McGinnes*, 283 F. 2d 333 (C.A. 3), certiorari denied, 364 U.S. 880; *Ward* v. *Commissioner*, 224 F. 2d 547 (C.A. 9); *Isaac G. Johnson & Co.* v. *United States*, 149 F. 2d 851 (C.A. 2); *Towanda Textiles, Inc.* v. *United States*, 180 F. Supp. 373 (Ct. Cl.).

of the acquisition cost of the securities." The Court did not adopt a transactional approach, as Hilton would have it. The Court's decision was that brokerage fees must be capitalized—and this did not depend on whether the fees were reckoned in separate transactions before or after the acquisition of the securities or simultaneously with the acquisition.

In *United States* v. *Gilmore,* 372 U.S. 39, this Court ruled that expenses incurred by the taxpayer in defending against his former wife's claim for alimony, and a community property settlement incident to divorce, were personal and, therefore, nondeductible expenses, even though the taxpayer would have suffered business injury if the wife's claim had been successful. In reaching this conclusion, the Court held (372 U.S. at 49) that the characterization of a litigation expenditure was dependent upon two criteria—the "origin and character of the claim with respect to which an expense was incurred." Since the "origin" of the ex-wife's claim, with respect to which the litigation expenses were incurred, lay in the marital relationship, and since the "character" of that claim was personal, the litigation expenses were not deductible.

Although *Gilmore* involved the question whether litigation expenses were business or personal expenses, its rationale applies with equal force in determining whether litigation expenses incurred in a profit-seeking context are subject to expense or capital treatment. Here the "origin" of Mrs. Quigley's claim to

payment for her shares, and the claim of the dissenting Waldorf shareholders, with respect to which the appraisal expenses were incurred, was the acquisition of their stock by Woodward and Hilton. The "character" of the claims—the amounts to be paid for capital assets—indisputably was capital in nature. Under the teaching of *Gilmore,* therefore, the appraisal costs may not be deducted.

Ignoring the decisions of this Court in *Helvering* v. *Winmill* and *United States* v. *Gilmore, supra,* the Seventh Circuit relied upon *Smith Hotel Enterprises, Inc.* v. *Nelson,* 236 F. Supp. 303 (E.D. Wis.), which held that a corporate taxpayer's litigation expenses paid in connection with an appraisal proceeding to fix the value of a dissenter's shares were deductible under Section 162.[9] In so holding, the district court followed *Heller* v. *Commissioner,* 147 F. 2d 376 (C.A. 9), affirming 2 T.C. 371, certiorari denied, 325 U.S. 868, cited by both Woodward (Br. 12, 40–43) and Hilton (Br. in Opp. 6, n. 13), where the Ninth Circuit held, prior to this Court's decision in *Gilmore,* that appraisal costs incurred by a dissenting shareholder were deductible under Section 212.[10] But the

[9] Squarely in conflict with *Smith Hotel* and the decision in *Hilton* is *Boulder Building Corp.* v. *United States,* 125 F. Supp. 512 (W.D. Okla.). The Eighth Circuit noted this conflict (R. 62) and endorsed *Boulder Building* as "[t]he better view."

[10] The district court in *Smith Hotel* also relied on the fact that the taxpayer's obligation to purchase the dissenter's shares was an "involuntary obligation." 236 F. Supp. at 305. Woodward similarly argues (Br. 21) that the appraisal expenses should not be capitalized because the majority shareholders were obligated to purchase Mrs. Quigley's stock under Iowa law

Ninth Circuit disapproved its *Heller* opinion in *Spangler* v. *Commissioner*, 323 F. 2d 913, 919–920, n. 15, where the taxpayer sought to deduct under Section 212 the litigation expenses of a suit in which he recovered, *inter alia*, the value of stock on a corporate liquidation. The court ruled that the litigation expenditure was a nondeductible capital outlay on the theory that costs connected with the acquisition of a capital asset, like "[c]osts connected with the disposition of a capital asset are also capital expenditures * * * rather than expenses deductible from ordinary income." 323 F. 2d at 921. See also *Ward* v. *Commissioner*, 224 F. 2d 547, 553–554 (C.A. 9). *Spangler*, and not *Heller*, represents the governing rule in the Ninth Circuit.[11]

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and did not do so voluntarily. The decisions to merge (in *Hilton*) and to extend the charter (in *Woodward*), however, were wholly voluntary. Moreover, the fact that an acquisition is involuntary is immaterial. As the Third Circuit stated in *Woolrich Woolen Mills* v. *United States*, 289 F. 2d 444, 448, "The involuntary nature of the expenditure * * * does not render deductible as expense an item which would otherwise be nondeductible as capital." See also *Teitelbaum* v. *Commissioner*, 294 F. 2d 541, 544 (C.A. 7), certiorari denied, 368 U.S. 987, and cases cited therein; *Russell Box Co.* v. *Commissioner*, 208 F. 2d 452, 454–455 (C.A. 1); *RKO Theatres, Inc.* v. *United States*, 163 F. Supp. 598 (Ct. Cl.).

[11] The correctness of *Naylor* v. *Commissioner*, 203 F. 2d 346 (C.A. 5), relied upon by Woodward (Br. 45, 47) and Hilton (Br. in Opp. 5, 9, 10) also has been questioned by the Ninth Circuit in *Spangler* (323 F. 2d, pp. 919–920, n. 15) and in 4A Mertens, Law of Federal Income Taxation (1966 rev. ed.), Section 25A.12, n. 40. *Naylor* is to be compared with the later decision of the Fifth Circuit in *United States* v. *St. Joe Paper Co.*, 284 F. 2d 430, which we believe represents the law of that circuit.

Like the district court in *Smith Hotel, supra,* the Seventh Circuit held that the "primary purpose" test enunciated in *Rassenfoss* v. *Commissioner,* 158 F. 2d 764 (C.A. 7), was applicable. The "primary purpose" test developed as an adjunct to the general rule that the cost of defending or perfecting title to property is a nondeductible capital expenditure. Treasury Regulations on Income Tax (1954 Code), Section 1.263 (a)–2(c), Appendix, *infra,* p. 30. Under this test, if litigation arises in a business or profit-seeking context, the attendant costs do not have to be capitalized merely because the end result of such litigation is the transfer of title to property; current deductibility is justified on the ground that the "primary purpose" of the litigation was something other than the defense or perfection of title. See, *e.g., Industrial Aggregate Co.* v. *United States,* 284 F. 2d 639, 645 (C.A. 8); *Manufacturers Hanover Trust Co.* v. *United States,* 312 F. 2d 785, 789–791 (Ct. Cl.).

It is apparent that the "primary purpose" test involving, as it must, a weighing of the title aspects of litigation against the other aspects of litigation, can have no bearing in these cases. The appraisal proceedings involved here were premised upon the obligation of both Woodward and Hilton to purchase the dissenters' shares. In these circumstances, neither the rule concerning defense or perfection of title, nor the adjunct "primary purpose" test is relevant.[12]

[12] Nothing in *Usry* v. *Price,* 325 F. 2d 657 (C.A. 5); *Vincent* v. *Commissioner,* 219 F. 2d 228 (C.A. 9); or *Gravois Planing Mill Co.* v. *Commissioner,* 299 F. 2d 199 (C.A. 8), relied upon

II. THE PRINCIPLE THAT EXPENSES INCURRED IN CONNECTION WITH THE ACQUISITION OF CAPITAL ASSETS MUST BE CAPITALIZED IS APPLICABLE TO BOTH CASES

Hilton's principal argument in its brief in opposition (pp. 11–14) is that its case is distinguishable from *Woodward* because, under New York law, the merger of Waldorf into Hilton became effective, and title to the dissenters' shares passed to Hilton, in advance of the appraisal proceeding. Hilton attempts to justify the Seventh Circuit's decision on the ground that it was based on the peculiarities of New York law (*id.* p. 11), and seems to agree that *Woodward* was correctly decided under Iowa law (*id.* p. 7). Woodward insists, despite the contrary finding of the Eighth Circuit (R. 55), that the Iowa law applicable to its appraisal proceeding is exactly like the New York law involved in Hilton. In short, Hilton asserts that

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by Hilton (Br. in Opp. 4, 5, 6), lends support to its position. In *Price*, the Fifth Circuit held that litigation expenses incurred to defend a quiet title action were currently deductible because of the peculiar circumstance there that the taxpayer's title had already been established by prior litigation which was res judicata. Compare, however, *Galewitz* v. *Commissioner*, 411 F. 2d 1374 (C.A. 2), certiorari denied, November 10, 1969 No. 485, O.T., 1969 (38 U.S. Law Week 3173). The Ninth Circuit's *Vincent* decision was premised on a theft loss theory (219 F. 2d at 231) which is irrelevant here; moreover, *Vincent* was criticized by the Ninth Circuit in *Spangler* v. *Commissioner*, *supra*, at 919–920, n. 15. *Gravois Planing Mill Co.*, holding that expenditures in connection with a partial liquidation may be deducted, presents a wholly different question and is to be contrasted with the subsequent decisions of the Eighth and Seventh Circuits in *United States* v. *Morton*, 387 F. 2d 441, 448–450 (C.A. 8), and *Alphaco, Inc.* v. *Nelson*, 385 F. 2d 244, 245 (C.A. 7).

the Eighth Circuit's decision in No. 412 is distinguishable, while Woodward argues it is wrong and seeks (Br. 22–26, 35–38) to bring its case within the ambit of the Seventh Circuit's title analysis.

We agree with Hilton that the Iowa law [13] construed by the Eighth Circuit is different, in terms of the timing of title passage from the New York law [14] interpreted by the Seventh Circuit. We disagree with Hilton, however, that the federal income tax treatment of appraisal expenses should turn on that difference. The other differences between the *Hilton* and *Woodward* cases, enumerated but not explicated in Hilton's brief in opposition (pp. 7–8), similarly do not warrant a difference in result.

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[13] The Iowa law (Iowa Code Ann. §491.25) provides that majority shareholders voting for renewal "shall have three years from the date such action for renewal was taken in which to purchase and pay for the stock voting against such renewal * * *." Under this language, the actual purchase of a dissenter's stock, with the attendant transfer of title, does not occur until after the purchase price has been fixed either through agreement or in an appraisal proceeding. While the obligation of the majority shareholders to purchase dissenters' shares arises on the date of the corporate renewal, as Woodward contends (Br. 35–36), neither the Iowa statute, nor any of the cases cited by Woodward, establish that dissenters lose any of their rights as stockholders, or that title passes to the majority shareholders, prior to the actual purchase of the dissenters' shares.

[14] Section 91(9) of the New York Stock Corporation Law provides that a corporate consolidation becomes effective upon the filing of the requisite certificate. Section 21(6) of the same law provides that as of the time of a merger vote, a dissenting shareholder loses all rights as such, except the right to receive payment for the value of his shares.

A. THE DIFFERENCE IN THE TIMING OF TITLE PASSAGE UNDER NEW YORK AND IOWA LAW IS NOT RELEVANT FOR FEDERAL INCOME TAX PURPOSES

The basic thrust of Hilton's argument is that the appraisal expenses it incurred were not part of the cost of acquisition of the shares of the dissenting Waldorf stockholders because, under New York law, Hilton had already acquired the shares. Woodward's appraisal expenses, on the other hand, were part of the cost of Mrs. Quigley's stock, in Hilton's view, because Woodward did not acquire that stock until after the price had been fixed in the appraisal proceeding.

This difference in the timing of title passage under New York and Iowa law cannot mask the fact that in *Hilton,* as well as in *Woodward,* the appraisal proceeding was directly related to the acquisition of dissenters' shares and, indeed, had no independent purpose of its own. Once the requisite shareholder vote had been taken in each case, the obligation to purchase the dissenters' shares was fixed. All that remained to be determined was the price to be paid for the shares. The fact that the appraisal proceeding occurred after the merger was effected in *Hilton* is of no moment, for the tax law often links together events that are temporally separated so long as they are functionally related. See *e.g., American Bantam Car Co.* v. *Commissioner,* 11 T.C. 397, 405, affirmed *per curiam,* 177 F. 2d 513 (C.A. 3), certiorari denied, 339 U.S. 920; *Kimbell-Diamond Milling Co.* v. *Commissioner,* 14 T.C. 74, affirmed *per curiam,* 187 F. 2d 718 (C.A. 5), certiorari denied, 342 U.S. 827. See also

Arrowsmith v. *Commissioner*, 344 U.S. 6; *United States* v. *Skelly Oil Co.*, 394 U.S. 678, 684–685.

Contrary to Hilton's assertion (Br. in Opp. 9), we do not contend that an expense must be capitalized merely because it "is incidental to, grows out of, or can be foreseen as a result of another [capital] transaction." The appraisal expenses incurred by Hilton were not merely incidental or forseeable expenses of Hilton's acquisition of dissenters' shares; they were inherent in the acquisition itself, since they were incurred in connection with an obligation to pay the dissenting Waldorf shareholders for the shares, which was an inseparable component of the acquisition.[15] The appraisal proceeding in *Hilton*, no less than in *Woodward*, was "inextricably woven into the fabric of the overall transaction" (R. 63).[16]

[15] To say, as the Seventh Circuit did (528–R. 40), that the "sole purpose" of the Hilton appraisal proceeding was to value the shares of the dissenting Waldorf stockholders, does not help Hilton's case. Rather, it reinforces the conclusion that the appraisal proceeding was an inherent part of the acquisition process.

[16] Hilton's theory that because of the provisions of New York law, the stock acquisition and the appraisal proceeding must be considered two independent events for tax purposes, leads ultimately to the conclusion that the price paid for the stock, as well as the appraisal expenses, may be deducted. For if the acquisition was an entirely separate event, Hilton paid nothing for the stock and its subsequent payment, occurring as it did after the passage of title and the effective date of the merger, was merely an incidental or foreseeable cost of the acquisition. Such a result, of course, is inconsistent with Section 263 and well-settled case law concerning capital expenditures, and Hilton has made no claim that the price paid for the stock itself is deductible.

Given the functional relationship between the stock acquisition and the appraisal proceeding in each of the instant cases, the tax treatment of the appraisal expenses in question cannot be controlled by the passage-of-title provisions of New York or Iowa law, which are based on policy considerations wholly different from those underlying Sections 162, 212 and 263. Numerous decisions of this Court make it clear that the refinements of title under state law do not govern federal tax consequences unless the revenue statutes explicitly or implicitly so provide. *Burnet* v. *Harmel,* 287 U.S. 103, 110–111; *Corliss* v. *Bowers,* 281 U.S. 376, 378; *Griffiths* v. *Commissioner,* 308 U.S. 355, 357; *Helvering* v. *Clifford,* 309 U.S. 331, 334; *Estate of Putnam* v. *Commissioner,* 324 U.S. 393, 395–396. Cf. *Biddle* v. *Commissioner,* 302 U.S. 573, 578–579. See also *Lyeth* v. *Hoey,* 305 U.S. 188, 194; *Morgan* v. *Commissioner,* 309 U.S. 78, 80; *Commissioner* v. *Sullivan,* 356 U.S. 27, 28–29.

In *Burnet* v. *Harmel, supra,* the taxpayer, who owned certain Texas oil lands in fee, executed oil and gas leases in exchange for cash payments and royalties and claimed capital gains treatment on the cash proceeds, relying upon the Texas law which provided that title to the oil and gas in place passed to the lessee immediately upon the execution of the leases. In rejecting this argument, this Court stated (287 U.S. at 110–111):

> * * * [W]e find in the Texas leases no differences from those leases where the title to the oil and gas passes only on severance by the lessee,

> which are of sufficient consequence to call for any different application of § 208. *The fact that title to the oil and gas is said to pass before severance, rather than after, is not such a difference.* * * * [Emphasis supplied.]

Similarly, the fact that title to the dissenters' shares here may have passed before, rather than after, the appraisal proceeding "is not such a difference" as to warrant a difference in the tax treatment of the appraisal expenses. As the Ninth Circuit observed in *Spangler* v. *Commissioner,* 323 F. 2d 913, 920, in holding that litigation expenses incurred in connection with the acquisition of stock must be capitalized, the refinements of title under state law are "irrelevant to the proper tax treatment of the costs of litigation." [17]

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[17] Hilton suggests (Br. in Opp. 12) that the law of New York is unique: "No other state's statutes cause a dissenting stockholder *prior* to the date the merger is effected to lose all his proprietary stock rights and be granted only the right to receive the value of the stock." On this basis it contends (*id.*, pp. 11–14) that a decision favorable to it would not apply under the laws of any other state. Even assuming that the federal tax treatment of appraisal expenses depends on state law, this is incorrect. As we noted in our petition (pp. 14–16), in every jurisdiction with the exception of West Virginia, a merger becomes effective, even if there are dissenting shareholders, upon the filing of an appropriate certificate in accordance with state law. Thus, outside of West Virginia, it can be argued under Hilton's theory that the appraisal proceeding is entirely separate from the merger. Hilton points out (Br. Opp. 13), however, that in its case both "[t]he loss of [dissenting shareholder] rights and the merger occurred long before the valuation proceedings." This is not unique under New York law. In 22 other jurisdictions, both events occur in advance of the appraisal proceeding (see Br. in Opp. 12–13, n. 39, points

B. THERE ARE NO OTHER DISTINCTIONS BETWEEN THE INSTANT CASES THAT WARRANT A DIFFERENCE IN THE FEDERAL INCOME TAX TREATMENT OF THE APPRAISAL EXPENSES IN QUESTION

Hilton points to a variety of other distinctions between its case and Woodward's (Br. in Opp. 6–8). Many of these simply are restatements of Hilton's principal argument on the timing of title passage, and we do not discuss them here. There seem to be three additional arguments that do not turn on the title passage aspect. These are the following: (1) that Hilton claimed its deduction under Section 162 of the Code, while Woodward's claim rests on Section 212; (2) that Hilton involves dissenters' rights arising out of a merger, while the dissenter's rights in *Woodward* arose because of the renewal of a corporate charter; and (3) that in *Hilton* the corporation acquired the dissenters' shares, while in *Woodward* the purchase was made by the majority shareholders.

None of these factual differences is significant. Hilton conceded as much in the district court when it abandoned its claim (R. 528–33) for deductibility of the expenses it incurred prior to the merger in the determination of a fair basis for the merger. If the distinctions had any merit either individually or collectively, they would have justified the deduction of the pre-merger expenses. The fact that they did not is best evidenced by Hilton's concession and the district

b, c, d and e), and in all of them it can be argued under Hilton's theory that the appraisal proceeding is a separate event for tax purposes.

court's holding (528–R. 33). They similarly do not justify the deduction of Hilton's appraisal expenses here in issue.

(1) *United States* v. *Gilmore,* 372 U.S. 39, 44–47, makes clear that the requirement that costs incurred in connection with the acquisition of a capital asset be capitalized applies equally to business expenditures otherwise deductible under Section 162 and to non-business expenditures otherwise deductible under Section 212. As the Eighth Circuit below recognized (R. 56–57), both Sections 162 and 212 are subject to the restriction of Section 263 against the deduction of capital expenditures.

Until 1942, "ordinary and necessary" expenses were deductible only if incurred in a "trade or business." See Section 23(a)(1) of the 1939 Code, which is the predecessor of Section 162(a). When Congress added the predecessor of Section 212 in the Revenue Act of 1942 (Section 23(a)(2) of the 1939 Code), it removed the bar that had previously existed to deductions incurred in profit-seeking activities that did not constitute a "trade or business." *Trust of Bingham* v. *Commissioner,* 325 U.S. 365; *Lykes* v. *United States,* 343 U.S. 118; Treasury Regulations (1954 Code), Section, 1.212–1(n), Appendix, *infra,* pp. 29–30; H. Rep. No. 2333, 77th Cong., 2d Sess., p. 75; S. Rep. No. 1631, 77th Cong., 2d Sess., p. 88. There is no support for Hilton's suggestion that an expenditure which would be considered capital if incurred in a Section 212 situation might somehow be a deductible expense if incurred in a trade or business.

(2) It is not entirely clear what significance Hilton

attempts to attribute to the fact that the dissenters' rights in *Woodward* arose out of the renewal of a corporate charter rather than a merger. Hilton's contention presumably is that, unlike *Woodward,* its case involves a reorganization and not a stock acquisition. Such an argument hardly comports with the facts, for in order to accomplish the merger, Hilton had to acquire all of the Waldorf shares not held by it. The obligation to exchange something of value for those Waldorf shares (Hilton stock for the assenting shareholders and cash for the dissenters) was an inherent part of the merger.

Moreover, as we have previously noted (p. 11, *supra*), the rule that expenses incurred in connection with a reorganization—here a merger described in Section 368(a)(1)(A) of the Code—must be capitalized is as firmly established as the parallel rule applicable to expenses incurred in connection with a stock acquisition. Indeed, the former rule was approved by Congress in 1954 when it enacted Section 248 of the 1954 Code, which permits amortization of certain organizational expenses of a corporation. Both the House and Senate Committee Reports on Section 248 state that "[e]xpenditures connected with the reorganization of a corporation are not incident to the creation of a corporation, and hence are not subject to the provisions of section 248." H. Rep. No. 1337, 83d Cong., 2d Sess., p. A64; S. Rep. No. 1622, 83d Cong., 2d Sess., p. 224. Thus, Hilton's expenses are to be treated like Woodward's, whether they are deemed to have arisen in connection with a stock acquisition or a reorganization.

(3) It can make no difference under Section 263 that a corporation acquired the dissenters' shares in *Hilton* and majority shareholders purchased the shares in *Woodward*. The determination whether an expenditure is a capital expenditure within the meaning of that provision depends only on the character of the expenditure.

In sum, *Hilton* and *Woodward* are, in all relevant respects indistinguishable. Neither the difference in the timing of title passage under New York and Iowa law, nor any other distinction suggested by Hilton, would support or justify different results in these cases. The proper result in each case is the capitalization of the appraisal expenses in question.

CONCLUSION

The decision of the Eighth Circuit in No. 412 should be affirmed; the decision of the Seventh Circuit in No. 528 should be reversed and the cause remanded to the district court with directions to dismiss the complaint.

Respectfully submitted.

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JANUARY 1970.

APPENDIX

Internal Revenue Code of 1954:

SEC. 162 [as amended by Sec. 4(b), Revenue Act of 1962, P.L. 87-834, 76 Stat. 976].

TRADE OR BUSINESS EXPENSES.

(a) *In General.*—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * * *

[26 U.S.C. 162.]

SEC. 212. EXPENSES FOR PRODUCTION OF INCOME.

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—

(1) for the production or collection of income;

(2) for the management, conservation, or maintenance of property held for the production of income; or

(3) in connection with the determination, collection, or refund of any tax.

[26 U.S.C. 212.]

SEC. 263. CAPITAL EXPENDITURES.

(a) *General Rule.*—No deduction shall be allowed for—

(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. This paragraph shall not apply to—

(A) expenditures for the development of mines or deposits deductible under section 616,

(B) research and experimental expenditures deductible under section 174,

(C) soil and water conservation expenditures deductible under section 175,

(D) [as added by Sec. 4, Act of September 14, 1960, P.L. 86–779, 74 Stat. 1001] expenditures by farmers for fertilizer, etc., deductible under section 180, or

(E) [as added by Sec. 21, Revenue Act of 1962, P.L. 87–834, 76 Stat. 1064] expenditures by farmers for clearing land deductible under section 182.

(2) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.

* * * * *

[26 U.S.C. 263.]

Treasury Regulations on Income Tax (1954 Code):

SEC. 1.212–1 *Nontrade or nonbusiness expenses.*

* * * * *

(n) Capital expenditures are not allowable as nontrade or nonbusiness expenses. The deduction of an item otherwise allowable under

section 212 will not be disallowed simply because the taxpayer was entitled under subtitle A of the Code to treat such item as a capital expenditure, rather than to deduct it as an expense. For example, see section 266. Where, however, the item may properly be treated only as a capital expenditure or where it was properly so treated under an option granted in subtitle A of the Code, no deduction is allowable under section 212; and this is true regardless of whether any basis adjustment is allowed under any other provision of the Code.

* * * * * *

[26 C.F.R. 1.212-1.]

Sec. 1.263(a)-2. *Examples of capital expenditures.*

The following paragraphs of this section include examples of capital expenditures:

(a) The cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year.

(b) Amounts expended for securing a copyright and plates, which remain the property of the person making the payments.

(c) The cost of defending or perfecting title to property.

(d) The amount expended for architect's services.

(e) Commissions paid in purchasing securities. Commissions paid in selling securities are an offset against the selling price, except that in the case of dealers in securities such commissions may be treated as an ordinary and necessary business expense.

(f) Amounts assessed and paid under an agreement between bondholders or shareholders of a corporation to be used in a reorganization of the corporation or voluntary contributions by shareholders to the capital of the corporation

for any corporate purpose. Such amounts are capital investments and are not deductible. See section 118 and § 1.118–1.

(g) A holding company which guarantees dividends at a specified rate on the stock of a subsidiary corporation for the purpose of securing new capital for the subsidiary and increasing the value of its stockholdings in the subsidiary shall not deduct amounts paid in carrying out this guaranty in computing its taxable income, but such payments are capital expenditures to be added to the cost of its stock in the subsidiary.

(h) The cost of good will in connection with the acquisition of the assets of a going concern is a capital expenditure.

[26 C.F.R. 1.263(a)–2.]

U.S. GOVERNMENT PRINTING OFFICE: 1970

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SUPREME COURT OF THE UNITED STATES

No. 412.—October Term, 1969

Fred W. Woodward, et al., Petitioners, *v.* Commissioner of Internal Revenue.	On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit.

[April 20, 1970]

Mr. Justice Marshall delivered the opinion of the Court.

This case, and *United States* v. *Hilton Hotels Corp.*, *post*, involve the tax treatment of expenses incurred in certain appraisal litigation.

Taxpayers owned or controlled a majority of the common stock of the Telegraph-Herald, an Iowa publishing corporation. The Telegraph-Herald was incorporated in 1901, and its charter was extended for 20-year periods in 1921 and 1941. On June 9, 1960, taxpayers voted their controlling share of the stock of the corporation in favor of a perpetual extension of the charter. A minority stockholder voted against the extension. Iowa law requires "those stockholders voting for such renewal . . . [to] purchase at its real value the stock voted against such renewal." Iowa Code Ann., § 491.25.

Taxpayers attempted to negotiate purchase of the dissenting stockholder's shares, but no agreement could be reached on the "real value" of those shares. Consequently, in 1962 taxpayers brought an action in state court to appraise the value of the minority stock interest. The trial court fixed a value, which was slightly reduced on appeal by the Iowa Supreme Court, *Wood-*

ward v. *Quigley*, 257 Iowa 1077, 133 N. W. 2d 38, *on rehearing*, 257 Iowa 1104, 136 N. W. 2d 280 (1965). In July 1965, taxpayers purchased the minority stock interest at the price fixed by the court.

During 1963, taxpayers paid attorneys', accountants', and appraisers' fees of over $25,000, for services rendered in connection with the appraisal litigation. On their 1963 federal income tax returns, taxpayers claimed deductions for these expenses, asserting that they were "ordinary and necessary expenses paid . . . for the management, conservation, or maintenance of property held for the production of income" deductible under § 212 of the Internal Revenue Code of 1954. The Commissioner of Internal Revenue disallowed the deduction "because the fees represent capital expenditures incurred in connection with the acquisition of capital stock of a corporation." The tax court sustained the Commissioner's determination, with two dissenting opinions, 49 T. C. 377 (1968), and the Court of Appeals affirmed, 410 F. 2d 313 (C. A. 8th Cir. 1969). We granted certiorari, 396 U. S. 875 (1969), to resolve the conflict over the deductibility of the costs of appraisal proceedings between this decision and the decision of the Court of Appeals for the Seventh Circuit in *United States* v. *Hilton Hotel Corp., supra.*[1] We affirm.

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[1] Other federal court decisions on the point are in conflict. Compare *Boulder Building Corp.* v. *United States*, 125 F. Supp. 512 (D. C. W. D. Okla. 1954) (holding appraisal proceeding costs capital expenditures), with *Smith Hotel Enterprises, Inc.* v. *Nelson*, 236 F. Supp. 303 (D. C. E. D. Wis. 1964) (holding such costs deductible or ordinary and necessary business expense). And see *Walter S. Heller*, 2 T. C. 371 (1943), aff'd *sub. nom. Heller* v. *Commissioner*, 147 F. 2d 376 (C. A. 9th Cir. 1945) (holding dissenting stockholder's appraisal costs deductible under predecessor to § 212).

See also *Naylor* v. *Commissioner*, 203 F. 2d 346 (C. A. 5th Cir. 1953), in which expenses of litigation to fix the purchase price of

Since the inception of the present federal income tax in 1913, capital expenditures have not been deductible.[2] See Internal Revenue Code of 1954, § 263. Such expenditures are added to the basis of the capital asset with respect to which they are incurred, and are taken into account for tax purposes either through depreciation or by reducing the capital gain (or increasing the loss) when the asset is sold. If an expense is capital, it cannot be deducted as "ordinary and necessary," either as a business expense under § 162 of the Code or as an expense of "management, conservation, or maintenance" under § 212.[3]

It has long been recognized, as a general matter, that costs incurred in the acquisition or disposition of a capital asset are to be treated as capital expenditures. The most familiar example of such treatment is the capitalization of brokerage fees for the sale or purchase of securities, as explicitly provided by longstanding Treasury regulation, Treas. Reg. 1.263 (a)–2 (e), and as approved by this Court in *Helvering* v. *Winmill*, 305 U. S. 79 (1938), and *Spreckels* v. *Commissioner*, 315 U. S. 626 (1942). The Court recognized that brokers' commissions are "part of the acquisition cost of the securities," *Helvering* v. *Winmill*, *supra*, at 84, and relied on the Treasury regulation, which had been approved by stat-

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stock sold pursuant to an option to purchase it at its net asset value on a certain date were held deductible under the predecessor to § 212.

[2] See § II (B) of the Income Tax Act of 1913, 38 Stat. 114, 167.

[3] The two sections are *in pari materia* with respect to the capital-ordinary distinction, differing only in that § 212 allows deductions for the ordinary and necessary expenses of nonbusiness profitmaking activities. See *United States* v. *Gilmore*, 372 U. S. 39, 44–45 (1963) *Walter S. Heller*, n. 1, *supra*, may have been based in part on the premise that the predecessor to § 212 permitted the deduction of some expenses that would have been capitalized if incurred in the conduct of a trade or business.

utory reenactment, to deny deductions for such commissions even to a taxpayer for whom they were a regular and recurring expense in his business of buying and selling securities.

The regulations do not specify other sorts of acquisition costs, but rather provide generally that "the cost of acquisition . . . of . . . property having a useful life substantially beyond the taxable year" is a capital expenditure. Treas. Reg. 1.263 (a)–2 (a). Under this general provision, the courts have held that legal, brokerage, accounting and similar costs incurred in the acquisition or disposition of such property are capital expenditures. See, *e. g., Spangler* v. *Commissioner,* 323 F. 2d 913, 921 (C. A. 9th Cir. 1963); *United States* v. *St. Joe Paper Co.,* 284 F. 2d 430, 432 (C. A. 5th Cir. 1960). See generally 4A J. Mertens, Law of Federal Income Taxation §§ 25.25, 25.26, 25.40, 25A.15 (1966 ed.). The law could hardly be otherwise, for such ancillary expenses incurred in acquiring or disposing of an asset are as much part of the cost of that asset as is the price paid for it.

More difficult questions arise with respect to another class of capital expenditures, those incurred in "defending or perfecting title to property." Treas. Reg. 1.263 (a)–2 (c). In one sense, any lawsuit brought against a taxpayer may affect his title to property—money, or other assets subject to lien.[4] The courts, not believing that Congress meant all litigation expenses to be capitalized, have created the rule that such expenses are capital in nature only where the taxpayer's "primary purpose" in incurring them is to defend or perfect title. See, *e. g., Rassenfoss* v. *Commissioner,* 158 F. 2d 764 (C. A. 7th Cir. 1946); *Industrial Aggregate Co.* v. *United*

[4] See *Hochschild* v. *Commissioner,* 161 F. 2d 817, 820 (C. A. 2d Cir. 1947) (Frank, J., dissenting).

States, 284 F. 2d 639, 645 (C. A. 8th Cir. 1960). This test hardly draws a bright line, and has produced a melange of decisions, which, as the Tax Court has noted, "it would idle to suggest . . . can be reconciled." *Hermann F. Ruoff*, 30 T. C. 204, 208 (1952).[5]

Taxpayers urge that this "primary purpose" test, developed in the context of cases involving the costs of defending property, should be applied to costs incurred in acquiring or disposing of property as well. And if it is so applied, they argue, the costs here in question were properly deducted, since the legal proceedings in which they were incurred did not directly involve the question of title to the minority stock, which all agreed was to pass to taxpayers, but rather was concerned solely with the value of that stock.[6]

We agree with the Tax Court and the Court of Appeals that the "primary purpose" test has no application here. That uncertain and difficult test may be the best that can be devised to determine the tax treatment of costs incurred in litigation that may affect a taxpayer's title to property more or less indirectly, and that thus calls for a judgment whether the taxpayer can fairly be said to be "defending or perfecting title." Such uncertainty is not called for in applying the regulation which makes the "cost of acquisition" of a capital asset a capital expense. In our view application of the latter regulation

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[5] A large number of these decisions are collected in 4A Mertens, *supra*, §§ 25.24, 25A.16.

[6] Taxpayers argue at length that under Iowa law title to the stock passed before the appraisal proceeding. The Court of Appeals viewed Iowa law differently, and it seems to us that it was correct in so doing. See *United States* v. *Hilton Hotels Corp.*, *post*, n. 2. But resolution of this question of state law makes no difference and is not necessary for decision of the case, since, as we hold in *Hilton Hotels*, the sequence in which title passes and price is determined is irrelevant for purposes of the tax question involved here.

to litigation expenses involves the simpler inquiry whether the origin of the claim litigated is in the process of acquisition itself.

A test based upon the taxpayer's "purpose" in undertaking or defending a particular piece of litigation would encourage resort to formalisms and artificial distinctions. For instance, in this case there can be no doubt that legal, accounting and appraisal costs incurred by taxpayers in *negotiating* a purchase of the minority stock would have been capital expenditures. See *Atzingen-Whitehouse Dairy, Inc.*, 36 T. C. 173 (1961). Under whatever test might be applied, such expenses would have clearly been "part of the acquisition cost" of the stock. *Helvering* v. *Winmill, supra.* Yet the appraisal proceeding was no more than the substitute which state law provided for the process of negotiation as a means of fixing the price at which the stock was to be purchased. Allowing deduction of expenses incurred in such a proceeding, merely on the ground that title was not directly put in question in the particular litigation, would be anomalous.

Further, a standard based on the origin of the claim litigated comports with this Court's most recent ruling on the characterization of litigation expenses for tax purposes. In *United States* v. *Gilmore*, 372 U. S. 39 (1963), this Court held that the expense of defending a divorce suit was a nondeductible personal expense, even though the outcome of the divorce case would affect the taxpayer's property holdings, and might affect his business reputation. The Court rejected a test which looked to the consequences of the litigation, and did not even consider the taxpayer's motives or purposes in undertaking defense of the litigation, but rather examined the origin and character of the claim against the taxpayer, and found that the claim arose out of the personal relationship of marriage

The standard here pronounced may, like any standard, present borderline cases, in which it is difficult to determine whether the origin of particular litigation lies in the process of acquisition.[7] This is not such a borderline case. Here state law required taxpayers to "purchase" the stock owned by the dissenters. In the absence of agreement on the price at which the purchase was to be made, litigation was required to fix the price. Where property is acquired by purchase, nothing is more clearly part of the process of acquisition than the establishment of a purchase price.[8] Thus the expenses incurred in that litigation were properly treated as part of the cost of the stock which the taxpayers acquired.

Affirmed.

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[7] See, *e. g.*, *Petschek* v. *United States*, 335 F. 2d 734 (C. A. 2d Cir. 1964), for a borderline case of whether legal expenses were occurred in the disposition of property.

[8] Taxpayers argue that "purchase" analysis cannot properly be applied to the appraisal situation, because the transaction is an involuntary one from their point of view—an argument relied upon by the District Court in the *Smith Hotel Enterprises* case, *supra*, n. 1. In the first place, the transaction is in a sense voluntary, since the majority holders know that under state law they will have to buy out any dissenters. More fundamentally, however, wherever a capital asset is transferred to a new owner in exchange for value either agreed upon or determined by law to be a fair *quid pro quo*, the payment itself is a capital expenditure, and there is no reason why the costs of determining the amount of that payment should be considered capital in the case of the negotiated price and yet considered deductible in the case of the price fixed by law. See *Isaac G. Johnson & Co.* v. *United States*, 149 F. 2d 851 (C. A. 2d Cir. 1945) (expenses of litigating amount of fair compensation in condemnation proceeding held capital expenditures).